103

MISCELLANEOUS REVENUE ISSUES

Y 4. W 36: 103-64

Miscellaneous Revenue Issues, Seria...

HEARINGS

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

JUNE 17, 22, 24; JULY 13, 1993; AND SEPTEMBER 8, 21, 23, 1993

PART 2 OF 3

SEPTEMBER 8, 21, AND 23, 1993

Serial 103–64

Printed for the use of the Committee on Ways and Means

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U.S. GOVERNMENT PRINTING OFFICE
77–130 CC
WASHINGTON : 1994

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-044369-5

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CONTENTS

Page

Part 1 (June 17, 22, 24; and July 13, 1993) 1
Part 2 (September 8, 21, and 23, 1993) 1055
Part 3 (Submissions for the Record—Revenue losers and revenue raisers) 1787

Press releases announcing the hearings 2

WITNESSES

U.S. Department of the Treasury, Hon. Leslie B. Samuels, Assistant Secretary for Tax Policy:
  June 22, 1993 299
  September 21, 1993 1397
U.S. Department of Commerce, Diana H. Josephson, Deputy Under Secretary for Oceans and Atmosphere, National Oceanic and Atmospheric Administration 353
U.S. General Accounting Office, Natwar M. Gandhi, Associate Director, Tax Policy and Administration Issues, General Government Division, Tom Short, Assignment Manager, and David Pasquarello, Evaluator, Philadelphia GAO 1421

Abrahamson, Gen. James A., Oracle Corp., and FSC Software Coalition 638
Actors' Equity Association, Ron Silver and Mark J. Weinstein 1121
Ad Hoc Group to Preserve Deduction for Advertising, Mark McConaghy 1171
Advanced Micro Devices, Cliff Jernigan 265
Advertising Tax Coalition
  Timothy White 1179
  Dewitt F. Helm, Jr 1184
Aerospace Industries Association, Douglas C. McPherson 668
Aerospace States Association (*see listing for* Hon. C. Michael Callihan)
Air Transport Association of America, Edward A. Merlis 1303
Alfers, Stephen D., Mineral Resources Alliance 1265
Alliance for Collaborative Research, Larry W. Sumney 371
Alliance for Responsible CFC Policy, Kevin J. Fay 1709
Alliance of American Insurers, Robert Jarratt 1488
Alliance to Save Energy, Mary Beth Zimmerman 699
Allis, John E., Houston, Tex 1536
American Agriculture Movement, Inc., Harvey Joe Sanner 1740
American Bankers Association, Taxation Committee, Lynda A. Kern 192
American Bar Association, Section of Taxation, Committee on S Corporations, Jordan P. Rose 434
American Express Travel Related Services, Co., Richard P. Romeo 1153
American Farmland Trust, Edward Thompson, Jr 801
American Federation of Television & Radio Artists, Ron Silver and Mark Weinstein 1121
American Financial Services Association, Richard P. Romeo 1153
American Football Coaches Association, Charles McClendon 91
American Institute of Certified Public Accountants:
  Gerald W. Padwe 466
  Pamela J. Pecarich 1454
American Insurance Association, Robert Rahn 1500

	Page
American Iron Ore Association, John L. Kelly	1275
American Land Title Association, Irving Morgenroth	1037
American Nuclear Insurers, Robert Rahn	1500
American Public Power Association, Stephen F. Johnson	770
American Society of Association Executives, Susan Bitter Smith	1335
American Vintners Association, Herbert Schmidt	141
American Wind Energy Association, Michael L. Marvin	756
AmSouth Bank N.A., Lynda A. Kern	192
Aponte, Angelo J., National Council of State Housing Agencies, and New York State Division of Housing and Community Renewal	876
Arizona Cable Television Association, Susan Bitter Smith	1335
Arndt, Aurel M., National League of Cities, et al; and Lehigh County Authority	979
Associated Builders & Contractors, Inc.:	
Robert Permison and Bernard Leibtag	427
Don Owen	1547
Associated General Contractors of America, Robert J. Desjardins	
July 13, 1993	1030
September 21, 1993	1553
Association of American Railroads, Edwin L. Harper	514
Association of Christian Schools International, John C. Holmes	1082
Association of Independent Colleges of Art and Design, Fred Lazarus IV	1103
Association of Local Housing Finance Agencies, Stephen G. Leeper	887
Association of National Advertisers, Inc., Dewitt F. Helm, Jr	1184
Bacchus, Hon. Jim, a Representative in Congress from the State of Florida	989
Baptist Foundation of Oklahoma, James H. Lockhart	1768
Barlow, Hon. Thomas J. III, a Representative in Congress from the State of Kentucky	1598
Bartsch, Charles, Northeast Midwest Institute	840
Battle Fowler Law Offices, Richard L. O'Toole	227
Beard, E. Lee, Business Women's Golf*Link, and First Federal Savings	1325
Bechtel Construction Co., Michael E. Martello	1043
Berman, Hon. Howard L., a Representative in Congress from the State of California	100
Bloch, Robert A., Gordonsville, Va	794
Borton, Pamela K., Council for Rural Housing and Development, and Southwind Management Company	902
Bouldin, Kenneth A., CDLA Computer Leasing & Remarketing Association	272
Bretagne Corp., Virginia Lazenby:	
June 24, 1993	691
September 8, 1993	1242
Bristol Savings Bank of Connecticut, Edward P. Lorenson	562
Brooklyn Union Gas Co., Fred J. Gentile	1632
Bryn Awel Corp., Gerald J. Herr	1558
Buford, Sharnia "Tab," City National Bank of Newark	233
Building Owners & Managers Association International:	
James C. Dinegar	1738
Thomas B. McChesney	254
Bunning, Hon. Jim, a Representative in Congress from the State of Kentucky	1595
Business Women's Golf*Link, E. Lee Beard	1325
Cahan, Cora, New 42nd Street, Inc	361
California Association of Winegrape Growers, Robert P. Hartzell	1648
California Carrot Board, John Guerard	1662
California League of Savings Institutions, Henry W. Schmidt, Jr	1309
California Pistachio Commission, Joseph C. MacIlvaine	1655
California Water Service Co., Donald L. Houck	132
Callihan, Hon. C. Michael, Lieutenant Governor of Colorado; and Aerospace States Association, as presented by Hon. Joel Hefley, a Representative in Congress from Colorado	865
Campbell, Robert H., Independent Refiners Coalition, and Sun Co., Inc	1229
Capon, Ross, National Association of Railroad Passengers	518
Carbonic Industries Corp., J. Vernon Hinely	1760
CDLA Computer Leasing & Remarketing Association, Kenneth A. Bouldin	272
Central State Life Insurance Co., Virginia Kirkland Shehee	158
Chemical Manufacturers Association, Thomas G. Singley	1472
Chicago Title & Trust Co., B. Wyckliffe Pattishall	1673
Chicago, City of, Hon. Richard M. Daley, Mayor	830

Page
Cianbro Corp., Robert J. Desjardins:
  July 13, 1993 1030
  September 21, 1993 1553
City National Bank of Newark, Sharnia "Tab" Buford 233
Cleveland-Cliffs, Inc., John L. Kelly 1275
Coalition for Asset Backed Securities, Donald B. Susswein 214
Coalition for the Fair Treatment of Environmental Cleanup Costs, Wayne Robinson 1626
Coalition on Energy Taxes, R. David Damron 1254
Coalition to Eliminate Tax Barriers to Environmental Cleanup, Fred J. Gentile 1632
Coalition to Preserve the Current Deductibility of Environmental Remediation Costs, Roy E. Hock 1604
Cohber Press, Inc., Howard C. Webber, Jr 1209
Cohen, Sheldon S., Leadership Council on Advertising Issues 1192
Colorado, State of (*see listing for* Hon. C. Michael Callihan)
Commercial Finance Association, Louis Eliasberg, Jr 201
Committee for Competition Through Advertising, Gerald Z. Gibian 1164
Community Bankers Association of Illinois, David E. Manning 208
Computer & Business Equipment Manufacturers Association, Robert Mattson 645
Conference of Chief Justices, and Conference of State Court Administrators, Hon. Thomas R. Phillips, Chief Justice 71
Construction Financial Management Association, Gerald J. Herr 1558
Contos, Larry, National Grocers Association, and Pay Less Supermarkets, Inc 523
Coopers & Lybrand, Ronald T. Maheu 1754
Corneel, Frederic G., Sullivan & Worcester 479
Costello, Hon. Jerry F., a Representative in Congress from the State of Illinois 64
Council for Rural Housing and Development, Pamela K. Borton 902
Cox, Dale, Independent Bakers Association 1094
Crispin, Robert W., Travelers Corp 180
Crop Protection Coalition, Richard Douglas 1745
Dakin, William G., National Association of Manufacturers, and Mobil Corp 1431
Daley, Hon. Richard M., Mayor, City of Chicago 830
Damron, R. David, Petrochemical Energy Group, Coalition on Energy Taxes, and Hoechst Celanese Corp 1254
DeFazio, Hon. Peter A., a Representative in Congress from the State of Oregon 59
Desjardins, Robert J., Associated General Contractors of America, and Cianbro Corp.:
  July 13, 1993 1030
  September 21, 1993 1553
Destec Energy, Inc., Tom Remar 677
Dinegar, James C., Building Owners & Managers Association International 1738
Disabled American Veterans, John F. Heilman 120
Douglas, Richard, Crop Protection Coalition, and Sun-Diamond Growers of California 1745
Dyer, Randy (*see listing for* National Structured Settlement Trade Association)
Education Finance Council, Lawrence W. O'Toole 1136
Ege, Karl J., Frank Russell Co. and Frank Russell Investment Management Co 593
Electronic Industries Association, Peter F. McCloskey:
  July 13, 1993 622
  September 21, 1993 1464
Eliasberg, Louis, Jr., Commercial Finance Association, and Finance Company of America 201
Elliott, Gary, National Wood Energy Association 751
Emergency Committee for American Trade, Raymond J. Wiacek 1528
Emil Buehler Perpetual Trust, Ira J. Kaltman 420
Erlandson, Dawn, Friends of the Earth 1294
Estee Lauder Co., Gerald Z. Gibian 1164
Farren, Michael J., Xerox Corp 631
Fay, Kevin J., Alliance for Responsible CFC Policy 1709
Feeney, David L., National Retail Federation, and R.H. Macy & Co., Inc 1203

	Page
Feulner, Edwin J., Jr. (*see listing for* Heritage Foundation)	
Finance Company of America, Louis Eliasberg, Jr	201
Fink, Matthew P., Investment Company Institute	572
Firemen's Association of the State of New York, Kenneth E. Newton	105
First Colony Life Insurance Co., Andrew Larsen	174
First Federal Savings, E. Lee Beard	1325
Florida Clinical Practice Association, Inc., Stanley W. Rosenkranz	1106
Florida Farm Bureau Casualty Insurance Co., Robert Jarratt	1488
Florida Farm Bureau General Insurance Co., Robert Jarratt	1488
Forest Industries Council on Taxation, Bartow S. Shaw, Jr	682
Frank Russell Co., and Frank Russell Investment Management Co., Karl J. Ege, and Warren Thompson	593
Friends of the Earth, Dawn Erlandson	1284
FSC Software Coalition, Gen. James A. Abrahamson	638
Gackenbach, Julie Leigh, U.S. Chamber of Commerce	1444
GenCorp, Wayne Robinson	1626
General Dynamics Corp., Douglas C. McPherson	668
General Motors Corp., G. Mustafa Mohatarem	262
Gentile, Fred J., Coalition to Eliminate Tax Barriers to Environmental Cleanup, and Brooklyn Union Gas Co	1632
Gentile, Peter A., North American Reinsurance Corp	1480
Geothermal Resources Association, Thomas C. Hinrichs	766
Gibian, Gerald Z., Estee Lauder Co., and Committee for Competition Through Advertising	1164
Gill, Charles B., National Rural Utilities Cooperative Finance Corp	1346
Girard, William C. "Chris," National Association of Convenience Stores, and Plaid Pantries	538
Glunt, Roger C., (*see listing for* National Association of Home Builders)	
Golden State Mutual Life Insurance Co., Larkin Teasley	187
Graphic Arts Legislative Council, Howard C. Webber, Jr	1209
Great Western Financial Corp., Michael Palko (*see listing for* Savings & Community Bankers of America)	
Green, Robert H., National Foreign Trade Council, Inc	1507
Gregg. Robert S., Sequent Computer Systems, Inc	389
Griffin, James T., John D. and Catherine T. MacArthur Foundation	402
Grubb & Ellis Co., Thomas B. McChesney	254
Guerard, John, California Carrot Board, and Wm. Bolthouse Farms, Inc	1662
Hamrick, Stephen H., Investment Program Association, and PaineWebber Inc	496
Harman, Hon. Jane, a Representative in Congress from the State of California	1073
Harper, Edwin L., Association of American Railroads	514
Hartzell, Robert P., California Association of Winegrape Growers	1648
Hecht, Marjorie Mazel, 21st Century Science & Technology	1730
Hefley, Hon. Joel, a Representative in Congress from the State of Colorado (*see listing for* Hon. C. Michael Callihan)	
Heilman, John F., Disabled American Veterans	120
Helm, Dewitt F., Jr., Advertising Tax Coalition, and Association of National Advertisers, Inc	1184
Henderson, Robert E., South Carolina Research Authority	973
Heritage Foundation, William J. Lehrfeld (on behalf of Edwin J. Faulner, Jr.)	1331
Herr, Gerald J., Construction Financial Management Association, and Bryn Awel Corp	1558
Hinely, J. Vernon, Carbonic Industries Corp	1760
Hinrichs, Thomas C., Geothermal Resources Association, and Magma Power Co	766
Hock, Roy E., Coalition to Preserve Deductibility of Environmental Remediation Costs, and Technitrol, Inc	1604
Hoechst Celanese Corp., R. David Damron	1254
Holmes, John C., Association of Christian Schools International	1082
Home Health Services and Staffing Association, James C. Pyles	1574
Hood, John A., National Assisted Management Association, and Volunteers of America	940
Horn, Hon. Stephen, a Representative in Congress from the State of California	1074
Houck, Donald L., National Association of Water Cos., and California Water Service Co	132

Page

Housing, Urban Redevelopment Authority of Pittsburgh, Stephen G. Leeper ... 887
Hughes, Vester T., Jr., Hughes & Luce ... 126
Hyman, Morton P., International Shipholding Corp.; Overseas Shipholding Group, Inc.; and OMI Corp ... 660
IBM Corp., Robert Mattson ... 645
Independent Bakers Association, Dale Cox ... 1094
Independent Petroleum Association of America, Virginia Lazenby:
  June 24, 1993 ... 691
  September 8, 1993 ... 1242
Independent Refiners Coalition, Robert H. Campbell ... 1229
International Shipholding Corp., Morton P. Hyman ... 660
Investment Company Institute, Matthew P. Fink ... 572
Investment Program Association, Stephen H. Hamrick, and Bruce H. Vincent 496
IRECO Inc./Dyno Nobel Inc., David G. Millett ... 527
Itel Corp., James E. Knox ... 585
Izaak Walton League of America, Maitland Sharpe ... 798
Jarratt, Robert, National Association of Independent Insurers, Alliance of American Insurers, National Association of Mutual Insurance Companies, Florida Farm Bureau Casualty Insurance Co., and Florida Farm Bureau General Insurance Co ... 1488
Jefferson, Hon. William J., a Representative in Congress from the State of Louisiana ... 58
Jernigan, Cliff, Semiconductor Industry Association, and Advanced Micro Devices ... 265
John D. and Catherine T. MacArthur Foundation, James T. Griffin ... 402
Johnson, Hon. Nancy L., a Representative in Congress from the State of Connecticut ... 41
Johnson, Stephen F., American Public Power Association, and Washington Public Utility Districts' Association ... 770
Joseph, Rachel A., National Congress of American Indians ... 557
Jung, Paul, Student Loan Interest Deduction Restoration Coalition ... 1016
Kalish, Mark, National Association of Home Builders ... 1436
Kaltman, Ira J., Emil Buehler Perpetual Trust ... 420
Kaman Corp., Glenn M. Messemer ... 277
Kelly, John L., American Iron Ore Association and Cleveland-Cliffs, Inc ... 1275
Kern, Lynda A., American Bankers Association, Taxation Committee; and AmSouth Bank N.A ... 192
Kies, Kenneth J., North American Reinsurance Corp ... 1480
Kilpatrick Life Insurance Co., Virginia Kilpatrick Shehee ... 158
Kleczka, Hon. Gerald D., a Representative in Congress from the State of Wisconsin ... 1372
Kmart Corp., James P. Sheridan ... 258
Knox, James E., Itel Corp ... 585
Land Insurance Title Co., Irving Morgenroth ... 1037
Lange, Robert T., Malvern, Pa ... 811
Larsen, Andrew, National Structured Settlement Trade Association, and First Colony Life Insurance Co ... 174
Lazarus, Fred, IV, Association of Independent Colleges of Art and Design ... 1103
Lazenby, Virginia:
  Independent Petroleum Association of America, and Bretagne Corp ... 691
  Independent Petroleum Association of America, Bretagne Corp., and National Stripper Well Association ... 1242
Leadership Council on Advertising Issues, Sheldon S. Cohen ... 1192
Lee, John W., College of William and Mary, Marshall-Wythe School of Law ... 1687
Leeper, Stephen G., Association of Local Housing Finance Agencies; and Housing, Urban Redevelopment Authority of Pittsburgh ... 887
Lehigh County Authority, Aurel M. Arndt ... 979
Lehman Brothers, Inc., R. Fenn Putnam ... 954
Lehrfeld, William J., Heritage Foundation ... 1331
Leibtag, Bernard, Associated Builders & Contractors, Inc ... 427
Levin, Hon. Sander M., a Representative in Congress from the State of Michigan ... 30
Levine, Howard J., Roberts & Holland ... 1680
Lewis, Terry, National Association of Housing Cooperatives ... 947
Lockhart, James H., Baptist Foundation of Oklahoma ... 1768
Longsworth, Nellie L., Preservation Action ... 929
Lorenson, Edward P., Savings & Community Bankers of America, and Bristol Savings Bank of Connecticut ... 562

Page
Louisiana Insurers' Conference, Virginia Kilpatrick Shehee 158
Lovain, Timothy, Trade Taxes Group 507
MacIlvaine, Joseph C., Western Growers Association, Western Pistachio Association, California Pistachio Commission, and Paramount Farming Co 1655
MAERP Reinsurance Association, Robert Rahn 1500
Magill, James N., Veterans of Foreign Wars of the United States 123
Magma Power Co., Thomas C. Hinrichs 766
Maheu, Ronald T., Coopers & Lybrand 1754
Mangis, Jon A., Oregon Department of Veterans' Affairs 990
Manning, David E., Community Bankers Association of Illinois 208
Martell, James G., Prime Group, Inc 838
Martello, Michael E., National Constructors Association, and Bechtel Construction Co 1043
Marvin, Michael L., American Wind Energy Association 756
Mattson, Robert, Computer & Business Equipment Manufacturers Association, and IBM Corp 645
Mayer, Matthew, Times Square Center Associates, and Park Tower Realty Corp 362
McChesney, Thomas B., Building Owners & Managers Association International, and Grubb & Ellis Co 254
McClendon, Charles, American Football Coaches Association 91
McCloskey, Peter F., Electronic Industries Association:
  June 24, 1993 622
  September 21, 1993 1464
McConaghy, Mark, Ad Hoc Group to Preserve Deduction for Advertising 1171
McPherson, Douglas C., Aerospace Industries Association, and General Dynamics Corp 668
Merlis, Edward, Air Transport Association of America 1303
Merrill Lynch & Co., Inc., LaBrenda Garrett Stodghill 580
Merrill, Peter, U.S. Multinational Corporation Tax Policy Coalition 1516
Messemer, Glenn M., Kaman Corp 277
Metzger, Philip C., New York State Office of Federal Affairs 788
Michigan State Hospital Finance Authority, and Michigan Higher Education Facilities Authority, Roy A. Pentilla 966
Millett, David G., IRECO Inc./Dyno Nobel Inc 527
Mineral Resources Alliance, Stephen D. Alfers 1265
Mobil Corp., William G. Dakin 1431
Mohatarem, G. Mustafa, General Motors Corp 262
Montgomery, Hon. G.V. (Sonny), Chairman, Committee on Veterans' Affairs, and a Representative in Congress from the State of Mississippi 46
Morgenroth, Irving, American Land Title Association, and Land Insurance Title Co 1037
Mutual Atomic Energy Liability Underwriters, Robert Rahn .....
National Assisted Management Association, John A. Hood 940
National Association of Computer Consultant Businesses, Harvey J. Shulman 110
National Association of Convenience Stores, William C. "Chris" Girard 538
National Association of Home Builders:
  J. Leon Peace, Jr. (on behalf of Roger C. Glunt) 893
  Mark Kalish (on behalf of Thomas N. Thompson) 1436
National Association of Housing Cooperatives, Terry Lewis 947
National Association of Independent Insurers, Robert Jarratt 1488
National Association of Manufacturers, William G. Dakin 1431
National Association of Mutual Insurance Cos., Robert Jarratt 1488
National Association of Railroad Passengers, Ross Capon 518
National Association of Water Cos., Donald L. Houck 132
National Congress of American Indians, Rachel A. Joseph 557
National Constructors Association, Michael E. Martello 1043
National Council of Health Facilities Finance Authorities, Roy A. Pentilla 966
National Council of State Housing Agencies, Angelo J. Aponte 876
National Foreign Trade Council, Inc., Robert H. Green 1507
National Grocers Association, Larry Contos 523
National Insurance Association, Larkin Teasley 187
National League of Cities, et al, Aurel M. Arndt 979
National Realty Committee:
  Stefan F. Tucker 1668
  William C. Rudin 247

Page
National Retail Federation:
  David L. Feeney ... 1203
  James P. Sheridan ... 258
National Rural Utilities Cooperative Finance Corp., Charles B. Gill ... 1346
National Staff Network, Marvin R. Selter ... 100
National Stripper Well Association, Virginia Lazenby ... 1242
National Structured Settlement Trade Association (Andrew Larsen on behalf of Randy Dyer) ... 174
National Trust for Historic Preservation, Harry K. Schwartz ... 918
National Volunteer Fire Council, Kenneth E. Newton ... 105
National Wood Energy Association, Gary Elliott ... 751
Native American Affairs, Subcommittee on, Committee on Natural Resources, Hon. Bill Richardson, Chairman, and a Representative in Congress from the State of New Mexico ... 292
Navajo Nation, Faith R. Roessel ... 549
New 42nd Street, Inc., Cora Cahan ... 361
New England Education Loan Marketing Corp., Lawrence W. O'Toole ... 1136
New York State Division of Housing and Community Renewal, Angelo J. Aponte ... 876
New York State office of Federal Affairs, Philip C. Metzger ... 788
Newspaper Association of America, Timothy White ... 1179
Newton, Kenneth E., Firemen's Association of the State of New York, and National Volunteer Fire Council ... 105
North American Reinsurance Corp., Peter A. Gentile and Kenneth J. Kies ... 1480
Northeast Midwest Institute, Charles Bartsch ... 840
NPES The Association for Suppliers of Printing & Publishing Technologies, Mark J. Nuzzaco ... 1215
Nurse Brokers and Contractors of America, Sally Sumner ... 1566
Nuzzaco, Mark J., NPES The Association for Suppliers of Printing & Publishing Technologies ... 1215
O'Connor, Edward A., Jr., Spaceport Florida Authority ... 998
O'Connor, James E., Savings and Community Bankers of America ... 1316
O'Toole, Lawrence W., New England Education Loan Marketing Corp., and Education Finance Council ... 1136
O'Toole, Richard L., Battle Fowler Law Offices ... 227
OMI Corp., Morton P. Hyman ... 660
Ono, Ruth M., Queen Emma Foundation ... 414
Oracle Corp., Gen. James A. Abrahamson ... 638
Oregon Department of Veterans' Affairs, Jon A. Mangis ... 990
Overseas Shipholding Group, Inc., Morton P. Hyman ... 660
Owen, Don Associated Builders & Contractors, Inc., and P&P Contractors ... 1547
P&P Contractors, Don Owen ... 1547
Padwe, Gerald W., American Institute of Certified Public Accountants ... 466
PaineWebber Inc., Stephen H. Hamrick ... 496
Palko, Michael, Great Western Financial Corp. (*see listing for* Savings & Community Bankers of America)
Paramount Farming Co., Joseph C. MacIlvaine ... 1655
Park Tower Realty Corp., Matthew Mayer ... 362
Pattishall, B. Wyckliffe, Chicago Title & Trust Co ... 1673
Pay Less Supermarkets, Inc., Larry Contos ... 523
Peace, J. Leon, Jr., National Association of Home Builders (*see listing for* Roger C. Glunt)
Pecarich, Pamela J., American Institute of Certified Public Accountants ... 1454
Pennell, Jeffrey N., Emory University School of Law ... 1776
Pentilla, Roy A., National Council of Health Facilities Finance Authorities, Michigan State Hospital Finance Authority, and Michigan Higher Education Facilities Authority ... 966
Permison, Robert, Associated Builders & Contractors, Inc ... 427
Petrochemical Energy Group, R. David Damron ... 1254
PHH Corp., Samuel H. Wright ... 1089
Phillips, Hon. Thomas R., Chief Justice, Supreme Court of Texas; Joint Task Force on Judicial Pension Plans; Conference of Chief Justices; and Conference of State Court Administrators ... 71
Plaid Pantries, William C. "Chris" Girard ... 538
PPG Industries, Inc., Donna Lee Walker ... 154
Preservation Action, Nellie L. Longsworth ... 929
Prime Group, Inc., James G. Martell ... 838
Printing Industries of America, Howard C. Webber, Jr ... 1209

Page

Public Securities Association, R. Fenn Putman, and Lehman Brothers, Inc 954
Pyles, James C., Home Health Services and Staffing Association 1574
Queen Emma Foundation, Ruth M. Ono 414
R.H. Macy & Co., Inc., David L. Feeney 1203
R.R. Donnelley & Sons Co., Frank Uvena 1148
Rahn, Robert, American Nuclear Insurers, American Insurance Association, Mutual Atomic Energy Liability Underwriters, and MAERP Reinsurance Association 1500
Ray, Cecil A., Jr., State Bar of Texas, Section of Taxation 814
Remar, Tom, WMX Technology & Services; Teco Energy, Inc., and Destec Energy, Inc 677
Renewable Fuels Association, Eric Vaughn 741
Reynolds, Hon. Mel, a Representative in Congress from the State of Illinois 857
Richardson, Hon. Bill, Chairman, Subcommittee on Native American Affairs, Committee on Natural Resources, and a Representative in Congress from the State of New Mexico 292
Robert Mondavi Winery, Herbert Schmidt 141
Robinson, Wayne, Coalition for the Fair Treatment of Environmental Cleanup Costs 1626
Roessel, Faith R., Navajo Nation 549
Romeo, Richard P., American Financial Services Association, and American Express Travel Related Services Co 1153
Rose, Jordan P., American Bar Association, Section of Taxation, Committee on S Corporations 434
Rosenkranz, Stanley W., Florida Clinical Practice Association, University of Florida Agency Funds, and University of South Florida College of Medicine's Faculty Practice Plan 1106
Roybal-Allard, Hon. Lucille, a Representative in Congress from the State of California 1072
Rudin, William C., National Realty Committee, and Rudin Management Co 247
Sanner, Harvey Joe, American Agriculture Movement, Inc 1740
Savings & Community Bankers of America:
    Edward P. Lorenson 562
    James E. O'Connor (on behalf of Michael Palko) 1316
Schmidt, Henry W., Jr. California League of Savings Institutions 1309
Schmidt, Herbert, American Vintners Association, and Robert Mondavi Winery 141
Schumer, Hon. Charles E., a Representative in Congress from the State of New York 859
Schwartz, Harry K., National Trust for Historic Preservation 918
Screen Actors Guild, Ron Silver, and Mark Weinstein 1121
Selter, Marvin R., National Staff Network 100
Semiconductor Industry Association, Cliff Jernigan 265
Semiconductor Research Corp., Larry W. Sumney 371
Sequent Computer Systems, Inc., Robert S. Gregg 389
Sharpe, Maitland, Izaak Walton League of America 798
Shaw, Bartow S., Forest Industries Council on Taxation 682
Shaw, Hon. E. Clay, Jr., a Representative in Congress from the State of Florida 35
Shehee, Virginia Kilpatrick, Louisiana Insurers' Conference, Kilpatrick Life Insurance, and Central State Life Insurance Co 158
Shell Oil Co., Thomas G. Singley 1472
Sheridan, James P., National Retail Federation, and Kmart Corp 258
Shulman, Harvey J., National Association of Computer Consultant Businesses 110
Silver, Ron, Actors' Equity Association, and Screen Actors Guild, and American Federation of Television & Radio Artists 1121
Singley, Thomas G., Chemical Manufacturers Association and Shell Oil Co 1472
Sklar, Scott, Solar Energy Industries Association 706
Smith, Anthony L., Southern California Edison Co., et al 733
Smith, Donald David, Western Commercial Space Center 1005
Smith, Hon. Nick, a Representative in Congress from the State of Michigan 82
Smith, Susan Bitter, Arizona Cable Television Association, and American Society of Association Executives 1335
Solar Energy Industries Association, Scott Sklar 706
Solomon, Michael F., Irvins, Phillips & Barker 1614
South Carolina Research Authority, Robert E. Henderson 973
Southern California Edison Co., et al, Anthony L. Smith 733

Page
Southwind Management Company, Pamela K. Borton 902
Spaceport Florida Authority, Edward A. O'Connor, Jr 998
Stodghill, LaBrenda Garrett, Merrill Lynch & Co., Inc 580
Strickland, Hon. Ted, a Representative in Congress from the State of Ohio 871
Studds, Hon. Gerry E., a Representative in Congress from the State of Massachusetts 49
Student Loan Interest Deduction Restoration Coalition, Paul Jung 1016
Sullivan & Worcester, Frederic G. Corneel 479
Sumner, Sally, Nurse Brokers and Contractors of America 1566
Sumney, Larry W., Alliance for Collaborative Research, and Semiconductor Research Corp 371
Sun Co., Inc., Robert H. Campbell 1129
Sun-Diamond Growers of California, Richard Douglas 1745
Susswein, Donald B., Coalition for Asset Backed Securities 214
Swift Energy Co., Bruce H. Vincent 496
Teasley, Larkin, National Insurance Association, and Golden State Mutual Life Insurance Co 187
Technitrol, Inc., Roy E. Hock 1604
Teco Energy, Inc., Tom Remar 677
Texas, State Bar of, Section of Taxation, Cecil A. Ray, Jr 814
Texas, Supreme Court of, Hon. Thomas R. Phillips, Chief Justice 71
Thompson, Edward, Jr., American Farmland Trust 801
Thompson, Thomas N. (*see* listing for National Association of Home Builders)
Thompson, Warren, Frank Russell Co., and Frank Russell Investment Management Co 593
Times Square Center Associates, Matthew Mayer and Dale W. Wickham 362
Times Union, Timothy White 1179
Torricelli, Hon. Robert G., a Representative in Congress from the State of New Jersey 52
Trade Taxes Group, Timothy Lovain 507
Travelers Corp., Robert W. Crispin 180
Tucker, Hon. Walter R. III, a Representative in Congress from the State of California 1057
Tucker, Stefan F., National Realty Committee 1668
Twenty-First (21st) Century Science & Technology, Marjorie Mazel Hecht 1730
U.S. Chamber of Commerce, Julie Leigh Gackenbach 1444
U.S. Multinational Corporation Tax Policy Coalition, Peter Merrill 1516
Uvena, Frank, R.R. Donnelley & Sons Co 1148
Vaughn, Eric, Renewable Fuels Association 741
Veterans of Foreign Wars of the United States, James N. Magill 123
Veterans' Affaris, Committee, Hon. G.V. (Sonny) Montgomery, and a Representative in Congress from the State of Mississippi 46
Vincent, Bruce H., Investment Program Association, and Swift Energy Co 496
Volunteers of America, John A. Hood 940
Walker, Donna Lee, PPG Industries, Inc 154
Washington Public Utility Districts' Association, Stephen F. Johnson 770
Waters, Hon. Maxine, a Representative in Congress from the State of California 1075
Webber, Howard C., Jr., Printing Industries of America, Graphic Arts Legislative Council, and Cohber Press, Inc 1209
Weinstein, Mark J., Screen Actors Guild, American Federation of Television and Radio Artists, Actors' Equity Association 1121
Western Commercial Space Center, Donald David Smith 1005
Western Growers Association, Joseph C. MacIlvaine 1655
Western Pistachio Association, Joseph C. MacIlvaine 1655
Wheat, Hon. Alan, a Representative in Congress from the State of Missouri 1384
White, Timothy, Times Union, Advertising Tax Coalition, and Newspaper Association of America 1179
Wiacek, Raymond J., Emergency Committee for American Trade 1528
Wickham, Dale W., Times Square Center Associates 362
Wm. Bolthouse Farms, Inc., John Guerard 1662
WMX Technology & Services, Tom Remar 677
Wright, Samuel H., PHH Corp 1089
Xerox Corp., Michael J. Farren 631
Zimmerman, Mary Beth, Alliance to Save Energy 699

SUBMISSIONS FOR THE RECORD

LISTING BY SUBJECT—REVENUE LOSERS

TAX ACCOUNTING

National Association of Regulatory Utility Commissioners, Linda Bisson Stevens, letter and attachments 1787

FINANCIAL INSTITUTIONS

Associated Bank, N.A, Neenah, Wis., Michael B. Mahlik, letter 1792
Bank Securities Association, statement 1793
Bank South, N.A., Atlanta, Ga., J. Blake Young, Jr., letter 1796
Barnett Banks Trust Co., N.A., Jacksonville, Fla., Michael C. Baker, letter 1797
Commerce Bancshares, Inc., Kansas City, Mo., John S. Archer, letter 1798
First Fidelity Bank, N.A., Newark, New Jersey, John J. Phillips, letter 1799
First National Bank of Chicago, Michael P. Traba, statement 1801
First Source Bank, South Bend, Ind., James P. Coleman, letter 1804
First Trust National Association, St. Paul, Minn., John M. Murphy, Jr., letter 1805
Hawaiian Trust Co., Ltd., Honolulu, Hawaii, Douglas Philpotts, letter 1807
Independent Bankers Association of America, James R. Lauffer, statement 1809
Investment Co. Institute, statement (*see listing under* Multiple Issues heading)
KPMG Peat Marwick, New York, N.Y., Kathy L. Anderson, letter 1811
Magna Trust Co., Belleville, Ill., Peter C. Merzian, letter 1812
Meridian Asset Management, Inc., Valley Forge, Pa., Robert C. Williams, letter 1813
Midlantic National Bank, Edison, N.J., A.J. DiMatties, letter 1814
Northern Trust Co., Chicago, Ill., Barry G. Hastings, letter 1815
Old Kent Bank and Trust Co., Grand Rapids, Mich., E. Philip Farley, letter 1816
Savings Bank Life Insurance Co., Woburn, Mass., Robert K. Sheridan, statement 1820
Securities Industry Association, Marc E. Lackritz, statement 1823
Security Trust Co., N.A., Baltimore, Md., Timothy J. Hynes III, letter 1817
Texas Commerce Investment Co., Houston, Tex.:
    H. Mitchell Harper, letter 1818
    William O. Leszinske, letter 1819

INSURANCE

Association of Financial Guaranty Insurers, William A. Geoghegan, statement and attachments 1837
Canadian Life and Health Insurance Association, Raymond L. Britt, Jr., and Mary V. Harcar, statement 1826
Colonial Life & Accident Insurance Co., Inc., Columbia, S.C., statement and attachment 1844
Mutual of America, Daniel W. Coyne, letter 1836

PASS-THROUGH ENTITIES

Alcoma Association, Inc., Lake Wales, Fla., Lawrence C. Updike, statement 1858
Arkansas Electric Cooperative Corp., Carl S. Whillock, letter 1870
Florida Bar, Tax Section, Jerald David August, statement 1849
Griffin Industries, Inc., Cold Spring, Ky., Dennis B. Griffin, statement 1864

Page
Investment Co. Institute, statement (*see listing under* Multiple Issues heading)
National Rural Electric Cooperative Association, Bob Bergland, statement 1871
Schnitzer Investment Corp., Portland, Ore., Kenneth M. Novack, statement ... 1866
Solo Cup Co., statement 1859
Wells Manufacturing Co., statement 1862

COST RECOVERY

American Automobile Manufacturers Association, statement 1883
D'Agostino Supermarkets, Inc., Larchmont, N.Y., Nicholas D'Agostino, Jr., letter 1885
Delta Queen Steamboat Co., New Orleans, La., statement 1876
Kennelly, Hon. Barbara B., a Representative in Congress from the State of Connecticut, statement (*see listing under* Multiple Issues heading)
National Association for the Self-Employed, Bennie L. Thayer, letter (*see listing under* Multiple Issues heading)
New York Cruise Lines, Inc., August J. Ceradini, Jr., letter 1879
Passenger Vessel Association, Eric G. Scharf, letter 1880
Sayville Ferry, Sayville, N.Y., Ken Stein, Jr., letter 1882

EMPLOYEE BENEFITS

AlliedSignal Inc., Ronald A. Sinaikin, statement 1908
American Legion, Steve A. Robertson, statement 1887
Bedford County (Va.) Circuit Court, Hon. William W. Sweeney, letter (forwarded by the Hon. L.F. Payne, a Representative in Congress from the State of Virginia) 1896
Chrysler Corp., Robert G. Liberatore, statement and attachment 1902
Committee of Annuity Insurers, statement and attachment 1898
Crisalli, Donna M., Washington, D.C., statement 1889
ESOP Association:
  Statement 1901
  J. Michael Keeling, statement 1906
Illinois Supreme Court, Hon. Benjamin K. Miller, Chief Justice, letter and attachment 1893
Investment Co. Institute, statement (*see listing under* Multiple Issues heading)
Kansas City Royals Baseball, Michael E. Herman, statement 1385
Kennelly, Hon. Barbara B., a Representative in Congress from the State of Connecticut, statement (*see listing under* Multiple Issues heading)
Non Commissioned Officers Association of the United States of America, Larry D. Rhea and Michael Ouelette, statement 1913
PPG Industries, Inc., Raymond W. LeBoeuf, statement 1911
Rahall, Hon. Nick J., II, a Representative in Congress from the State of West Virginia, statement 1890
Stump, Hon. Bob, a Representative in Congress from the State of Arizona, letter and attachment 1892

INDIVIDUAL

American Dental Association, statement and attachment 1926
American Society for Payroll Management, Robert D. Williamson, statement .. 1917
Associated Builders and Contractors, Inc., Charles E. Hawkins III, letter 1919
Building and Construction Trades Department, AFL-CIO, Robert A. Georgine, statement 1921
Construction Financial Management Association, Joseph J. Lozano, statement 1924
Johnson, Hon. Nancy L., a Representative in Congress from the State of Connecticut, statement 851
Military Coalition, Paul W. Arcari and Michael Ouellette, letter 1929

ESTATE AND GIFT

American Farm Bureau Federation, statement 1957
Appalachian Mountain Club, Boston, Mass., Jennifer Melville, statement 1942
Appalachian Trail Conference, Harpers Ferry, W.Va., John Stokes and David N. Startzell, statement 1943
Baptist Foundation of Oklahoma, James H. Lockhart, statement 1931

Page
Brandywine Conservancy, Chadds Ford, Pa., George A. Weymouth, statement 1945
Brennan, Edward V., Gray, Cary, Ames & Frye, La Jolla, Calif., statement and attachments 1934
Brewster, Hon. Bill, a Representative in Congress from the State of Oklahoma, statement 1932
Chesapeake Bay Foundation, Annapolis, Md., William C. Baker, letter 1946
Dutchess Land Conservancy, Stanfordville, N.Y., Ira Stern, statement 1947
Johnson, Hon. Nancy L., a Representative in Congress from the State of Connecticut, statement 609
Land Trust Alliance, Jean W. Hocker, statement 1948
Oregon Trout, Inc., Portland, Ore., Geoff Pampush, letter 1950
Platt, Ronald L., and Gregory F. Jenner, McDermott, Will & Emery, Washington, D.C., statement 1958
Save the Bay, Providence, R.I., Curt Spalding, letter 1951
South Carolina Coastal Conservation League, Charleston, S.C., Dana Beach, statement 1952
Ward L. Quaal Co., Ward L. Quaal, statement 1954
Worthy, K. Martin, Hopkins & Sutter, Washington, D.C., statement 611

FOREIGN TAX PROVISIONS

American Petroleum Institute, statement 1961
Bell Atlantic Corp., statement and attachment 1965
Beneficial Corp., Gary J. Perkinson, statement 2012
Birdsall, Inc., Riviera Beach, Fla., John H. Birdsall III, letter and attachments 1997
Cargill, Inc., Minneapolis, Minn., Bruce H. Barnett, statement and attachments 2028
Caribbean Latin American Action, Peter Johnson, letter 2009
Chevron Corp.:
    Statement 1985
    Statement 2016
Chubb Corp., Warren, N.J., Dean R. O'Hare, statement 1970
Committee on State Taxation, Mark Cahoon, statement 2026
Emergency Committee for American Trade, Robert L. McNeill, letter 1975
Evans Economics, Inc., Washington, D.C., Michael K. Evans, letter 2006
Federal-Mogul Corp., Detroit, Mich., Robert C. Rozycki, statement 2019
Federation of American Controlled Shipping, Philip J. Loree, statement 1987
General Motors Corp., statement 2014
Information Tecnology Association of America, Luanne James, statement 1984
Matsui, Hon. Robert T., a Representative in Congress from the State of California, statement 674
McClure, Trotter & Mentz, Chtd., Washington, D.C., William P. McClure, statement 2023
National Foreign Trade Council, Inc., statement 1976
Shaw, Hon. E. Clay, Jr., a Representative in Congress from the State of Florida, statement 1996
Tax Executives Institute, Inc., Robert H. Perlman, letter 1981

NATURAL RESOURCES

American Gas Association, statement 2062
American Methanol Institute, Raymond A. Lewis, statement 2069
American Public Power Association, Larry Hobart; National Rural Electric Cooperative Association, Bob Bergland; and National Association of Regulatory Utility Commissioners, Thomas Choman, joint letter 2095
City Utilities of Springfield, Mo., Robert E. Roundtree, letter (forwarded by the Hon. Mel Hancock, a Representative in Congress from the State of Missouri) 2074
Columbia Gas Development Corp., Houston, Tex., Robert C. Williams, Jr., statement 2050
Delson Lumber Co., Hardel Mutual Plywood Corp., Manke Lumber Co., and Conifer Pacific, joint statement 2034
Destec Energy, Inc., Houston, Tex., Charles F. Goff, statement 2040
Electric Transportation Coalition, Kateri A. Callahan, letter 2075
Independent Oil and Gas Association of West Virginia, Rich Heffelfinger, statement 2044

Page
Independent Petroleum Association of America, Roy W. Willis, letter ... 2080
Kenetech/U.S. Windpower, Robert T. Boyd, statement ... 2088
Large Public Power Council, and Salt River Project of Phoenix, Ariz., Mark Bonsall, statement ... 2085
Los Angeles, Calif., City of, statement ... 2083
Louisiana Land & Exploration Co., New Orleans, La., Leighton Steward, statement ... 2054
Matsui, Hon. Robert T., a Representative in Congress from the State of California, statement ... 730
MDU Resources Group, Inc., Bismark, N.Dak., Robert E. Wood, statement ... 2057
Mitchell Energy & Development Corp., The Woodlands, Tex., Craig G. Goodman, letter and attachment ... 2059
National Rural Electric Cooperative Association, Bob Bergland, statement ... 718
Natural Resources Defense Council, Marika Tatsutani, statement ... 2084
Northeast Public Power Association, Westborough, Mass., statement (*see listing under* Multiple Issues heading)
Northwest Independent Forest Manufacturers, Tacoma, Wash., M.J. "Gus" Kuehne, statement and attachment ... 2036
Sacramento, Calif., Municipal Utility District, statement ... 2096
Southern California Public Power Authority, Pasadena, Calif., statement ... 2086
Tampa (Fla.) Electric Co., statement ... 2042
USX Corp., statement ... 2091
Washington Citizens for World Trade, Olympia, Wash., Nicholas J. Kirkmire, statement ... 2093
Wise, Hon. Bob, a Representative in Congress from the State of West Virginia, letter and attachments ... 2045

HOUSING

Ford, Hon. Harold E., a Representative in Congress from the State of Tennesses, statement and attachment ... 849
J&B Management Co., Fort Lee, N.J., Bernard Rodin, statement ... 2110
Lowey, Hon. Nita M., a Representative in Congress from the State of New York, statement ... 2109
National Cooperative Business Center, Russell C. Notar, statement ... 2102
New York, City of, Hon. David N. Dinkins, Mayor, statement (*see listing under* Multiple Issues heading)
PacifiCorp Financial Services, Portland, Ore., William E. Peressini, statement ... 2098
Salem, Irving, and Carol A. Quinn, Latham & Watkins, New York, N.Y., statement ... 2104

TAX-EXEMPT BONDS

Alaska Aerospace Development Corp., Anchorage, Alaska, H.P. "Pat" Ladner, statement ... 2114
Alaska Housing Finance Corp., statement ... 2117
American Association of Port Authorities, Jean C. Godwin, letter ... 2146
American Public Power Association, Larry Hobart, statement ... 2133
Barca, Hon. Peter W., a Representative in Congress from the State of Wisconsin, statement ... 2129
Belz Investment Co., Inc., Memphis, Tenn., Jack A. Belz, statement (*see listing under* Multiple Issues heading)
Connecticut, State of, Hon. Joseph M. Suggs, Jr., statement ... 2127
Council of Development Finance Agencies, statement ... 2120
Edison Electric Institute, statement ... 2136
Kennelly, a Representative in Congress from the State of Connecticut, Hon. Barbara B. statement (*see listing under* Multiple Issues heading)
Kleczka, Hon. Gerald D., a Representative in Congress from the State of Wisconsin, statement ... 2131
Massachusetts Municipal Wholesale Electric Co., statement ... 2140
Matsui, Hon. Robert T., a Representative in Congress from the State of California:
  Statement ... 853
  Statement ... 855
National Association of Bond Lawyers, statement ... 2141

Page
National Association of Independent Colleges and Universities; American Council on Education; Association of American Universities, and National Association of State Universities and Land Grant Colleges, Richard F. Rosser, joint letter 2124
New Mexico, State of, Hon. Casey Luna, Lt. Governor, statement 2115
New York, City of, Hon. David N. Dinkins, Mayor, statement (*see listing under* Multiple Issues heading)
Northeast Public Power Association, Westborough, Mass., statement (*see listing under* Multiple Issues heading)
Stanford University, Stanford, Calif., Peter Van Etten, statement 2122
Texas Veterans Land Board, Austin, Tex., Garry Mauro, statement 2118
Wisconsin Department of Veterans Affairs, Daniel D. Stier, letter 2119

COMPLIANCE

Brewster, Hon. Bill K., a Representative in Congress from the State of Oklahoma, statement 1037

MISCELLANEOUS ISSUES

Allegheny Electric Cooperative, Inc., Harrisburg, Pa., Ed Uravic, letter 2178
American Bakers Association, Paul C. Abenante, letter 2191
American College of Trust and Estate Counsel, James M. Trapp, letter 2198
American Vintners Association, statement 2167
Arctic Slope Regional Corp., Goldbelt Corp., and Sealaska Corp., joint statement 2151
Art Institute of Southern California, Laguna Beach, Calif., John W. Lottes, letter 2159
Association of American Medical Colleges, Robert G. Petersdorf, M.D., letter 2193
Basin Electric Power Cooperative, Bismark, N.Dak., Robert L. McPhail, statement 2180
Belz Investment Co., Inc., Memphis, Tenn., Jack A. Belz, statement (*see listing under* Multiple Issues heading)
D'Amato, Hon. Alfonse M., a United States Senator from the State of New York, statement 2174
Dairymen, Inc., Boyd M. Cook, statement 2163
Harrington, Carol A., Kathryn G. Henkel, Carlyn S. McCaffrey, Lloyd Leva Plaine, and Pam H. Schneider, American Bar Association, Real Property, Probate & Trust Section, joint letter 2201
Harsch Investment Corp., Portland Ore., Harold and Arlene Schnitzer, statement 2160
Kanjorski, Hon. Paul E., a Representative in Congress from the State of Pennsylvania, statement 2169
Koncor Forest Products Co., Anchorage, Alaska, John Sturgeon, statement 2155
Maryville University, St. Louis, Mo., Keith Lovin, letter 2206
Moakley, Hon. John Joseph, a Representative in Congress from the State of Massachusetts, statement 2196
Myers, Robert J., Silver Spring, Md., statement 2195
National Association for the Self-Employed, Bennie L. Thayer, letter (*see listing under* Multiple Isssues heading)
National Presto Industries, Inc., Eau Claire, Wis., Joseph H. Berney, statement 2183
National Staff Leasing Association, Rob Lederer, letter 2186
Neal, Hon. Richard E., a Representative in Congress from the State of Massachusetts, statement 2197
New York, State of, Vincent Tese, statement 2176
Shoshone and Arapaho Tribes' Joint Business Council, Fort Washakie, Wyo., Richard L. Ortiz, letter and attachment 2148
Sierra Semiconductor Corp., James V. Diller, statement and attachments 2187
Southland Corp., Dallas, Tex., Ronald L. Platt, statement 2171
University of Arkansas, Fayetteville, Ark., A.H. Edwards, letter 2208
Western Farmers Electric Cooperative, Anadarko, Okla., James D. Pendergrass, statement 2165

MULTIPLE ISSUES

Belz Investment Co., Inc., Memphis, Tenn., Jack A. Belz, statement 2209
Investment Co. Institute, statement 2211

Page
Kennelly, Hon. Barbara B., a Representative in Congress from the State of Connecticut, statement 2219
National Association for the Self-Employed, Bennie L. Thayer, letter 2221
New York, City of, Hon. David N. Dinkins, Mayor, statement 2223
Northeast Public Power Association, Westborough, Mass., statement 2230

COMBINED LISTING BY NAME AND ORGANIZATION (LOSERS)

Abenante, Paul C., American Bakers Association, letter 2191
Alaska Aerospace Development Corp., Anchorage, Alaska, H.P. "Pat" Ladner, statement 2114
Alaska Housing Finance Corp., statement 2117
Alcoma Association, Inc., Lake Wales, Fla., Lawrence C. Updike, statement 1858
Allegheny Electric Cooperative, Inc., Harrisburg, Pa., Ed Uravic, letter 2178
AlliedSignal Inc., Ronald A. Sinaikin, statement 1908
American Association of Port Authorities, Jean C. Godwin, letter 2146
American Automobile Manufacturers Association, statement 1883
American Bakers Association, Paul C. Abenante, letter 2191
American College of Trust and Estate Counsel, James M. Trapp, letter 2198
American Council on Education, Richard F. Rosser, joint letter (*see listing for* National Association of Independent Colleges and Universities
American Dental Association, statement and attachment 1926
American Farm Bureau Federation, statement 1957
American Gas Association, statement 2062
American Legion, Steve A. Robertson, statement 1887
American Methanol Institute, Raymond A. Lewis, statement 2069
American Petroleum Institute, statement 1961
American Public Power Association, Larry Hobart, statement 2133
American Public Power Association, Larry Hobart; National Rural Electric Cooperative Association, Bob Bergland; and National Association of Regulatory Utility Commissioners, Thomas Choman, joint letter 2095
American Society for Payroll Management, Robert D. Williamson, statement 1917
American Vintners Association, statement 2167
Anderson, Kathy L., KPMG Peat Marwick, New York, N.Y., letter 1811
Appalachian Mountain Club, Boston, Mass., Jennifer Melville, statement 1942
Appalachian Trail Conference, Harpers Ferry, W.Va., John Stokes and David N. Startzell, statement 1943
Arcari, Paul W., Military Coalition, letter 1929
Archer, John S., Commerce Bancshares, Inc., Kansas City, Mo., letter 1798
Arctic Slope Regional Corp., Goldbelt Corp., and Sealaska Corp., joint statement 2151
Arkansas Electric Cooperative Corp., Carl S. Whillock, letter 1870
Art Institute of Southern California, Laguna Beach, Calif., John W. Lottes, letter 2159
Associated Bank, N.A, Neenah, Wis., Michael B. Mahlik, letter 1792
Associated Builders and Contractors, Inc., Charles E. Hawkins III, letter 1919
Association of American Medical Colleges, Robert G. Petersdorf, M.D., letter 2193
Association of American Universities (*see listing for* National Association of Independent Colleges and Universities)
Association of Financial Guaranty Insurers, William A. Geoghegan, statement and attachments 1837
August, Jerald David, Florida Bar, Tax Section, statement 1849
Baker, Michael C., Barnett Banks Trust Co., N.A., Jacksonville, Fla., letter 1797
Baker, William C., Chesapeake Bay Foundation, Annapolis, Md., letter 1946
Bank Securities Association, statement 1793
Bank South, N.A., Atlanta, Ga., J. Blake Young, Jr., letter 1796
Baptist Foundation of Oklahoma, James H. Lockhart, statement 1931
Barca, Hon. Peter W., a Representative in Congress from the State of Wisconsin, statement 2129
Barnett Banks Trust Co., N.A., Jacksonville, Fla., Michael C. Baker, letter 1797
Barnett, Bruce H., Cargill, Inc., Minneapolis, Minn., statement and attachments 2028
Basin Electric Power Cooperative, Bismark, N.Dak., Robert L. McPhail, statement 2180
Beach, Dana, South Carolina Coastal Conservation League, Charleston, S.C., statement 1952

Page

- Bedford County (Va.) Circuit Court, Hon. William W. Sweeney, letter (forwarded by the Hon. L.F. Payne, a Representative in Congress from the State of Virginia) 1896
- Bell Atlantic Corp., statement and attachment 1965
- Belz Investment Co., Inc., Memphis, Tenn., Jack A. Belz, statement 2209
- Beneficial Corp., Gary J. Perkinson, statement 2012
- Bergland, Bob, National Rural Electric Cooperative Association:
  - Statement 718
  - Statement 1871
  - Joint letter (*see listing for* American Public Power Association)
- Berney, Joseph H., National Presto Industries, Inc., Eau Claire, Wis., statement 2183
- Birdsall, Inc., Riviera Beach, Fla., John H. Birdsall III, letter and attachments 1997
- Bonsall, Mark, Large Public Power Council, and Salt River Project of Phoenix, Ariz., statement 2085
- Boyd, Robert T., Kenetech/U.S. Windpower, statement 2088
- Brandywine Conservancy, Chadds Ford, Pa., George A. Weymouth, statement 1945
- Brennan, Edward V., Gray, Cary, Ames & Frye, La Jolla, Calif., statement and attachments 1934
- Brewster, Hon. Bill, a Representative in Congress from the State of Oklahoma:
  - Statement 1932
  - Statement 1037
- Britt, Raymond L., Jr., Canadian Life and Health Insurance Association, statement 1826
- Building and Construction Trades Department, AFL-CIO, Robert A. Georgine, statement 1921
- Cahoon, Mark, Committee on State Taxation, statement 2026
- Callahan, Kateri A., Electric Transportation Coalition, letter 2075
- Canadian Life and Health Insurance Association, Raymond L. Britt, Jr., and Mary V. Harcar, statement 1826
- Cargill, Inc., Minneapolis, Minn., Bruce H. Barnett, statement and attachments 2028
- Caribbean Latin American Action, Peter Johnson, letter 2009
- Ceradini, Jr., August J., New York Cruise Lines, Inc., letter 1879
- Chesapeake Bay Foundation, Annapolis, Md., William C. Baker, letter 1946
- Chevron Corp.:
  - Statement 1985
  - Statement 2016
- Choman, Thomas, National Association of Regulatory Utililty Commissioners, joint letter (*see listing for* American Public Power Association)
- Chrysler Corp., Robert G. Liberatore, statement and attachment 1902
- Chubb Corp., Warren, N.J., Dean R. O'Hare, statement 1970
- City Utilities of Springfield, Mo., Robert E. Roundtree, letter (forwarded by the Hon. Mel Hancock, a Representative in Congress from the State of Missouri) 2074
- Coleman, James P., First Source Bank, South Bend, Ind., letter 1804
- Colonial Life & Accident Insurance Co., Inc., Columbia, S.C., statement and attachment 1844
- Columbia Gas Development Corp., Houston, Tex., Robert C. Williams, Jr., statement 2050
- Commerce Bancshares, Inc., Kansas City, Mo., John S. Archer, letter 1798
- Committee of Annuity Insurers, statement and attachment 1898
- Committee on State Taxation, Mark Cahoon, statement 2026
- Conifer Pacific, joint statement (*see listing for* Delson Lumber Co.)
- Connecticut, State of, Hon. Joseph M. Suggs, Jr., statement 2127
- Construction Financial Management Association, Joseph J. Lozano, statement 1924
- Cook, Boyd M., Dairymen, Inc., statement 2163
- Council of Development Finance Agencies, statement 2120
- Coyne, Daniel W., Mutual of America, letter 1836
- Crisalli, Donna M., Washington, D.C., statement 1889
- D'Agostino Supermarkets, Inc., Larchmont, N.Y., Nicholas D'Agostino, Jr., letter 1885
- D'Amato, Hon. Alfonse M., a United States Senator from the State of New York, statement 2174

Page
Dairymen, Inc., Boyd M. Cook, statement 2163
Delson Lumber Co., Hardel Mutual Plywood Corp., Manke Lumber Co., and Conifer Pacific, joint statement 2034
Delta Queen Steamboat Co., New Orleans, La., statement 1876
Destec Energy, Inc., Houston, Tex., Charles F. Goff, statement 2040
Diller, James V., Sierra Semiconductor Corp., statement and attachments 2187
DiMatties, A.J., Midlantic National Bank, Edison, N.J., letter 1814
Dinkins, Hon. David N., Mayor, City of New York, statement 2223
Dutchess Land Conservancy, Stanfordville, N.Y., Ira Stern, statement 1947
Edison Electric Institute, statement 2136
Edwards, A.H., University of Arkansas, Fayetteville, Ark., letter 2208
Electric Transportation Coalition, Kateri A. Callahan, letter 2075
Emergency Committee for American Trade, Robert L. McNeill, letter 1975
ESOP Association:
  Statement 1901
  J. Michael Keeling, statement 1906
Evans Economics, Inc., Washington, D.C., Michael K. Evans, letter 2006
Farley, E. Philip, Old Kent Bank and Trust Co., Grand Rapids, Mich., letter .. 1816
Federal-Mogul Corp., Detroit, Mich., Robert C. Rozycki, statement 2019
Federation of American Controlled Shipping, Philip J. Loree, statement 1987
First Fidelity Bank, N.A., New Jersey, John J. Phillips, letter 1799
First National Bank of Chicago, Michael P. Traba, statement 1801
First Source Bank, South Bend, Ind., James P. Coleman, letter 1804
First Trust National Association, St. Paul, Minn., John M. Murphy, Jr., letter 1805
Florida Bar, Tax Section, Jerald David August, statement 1849
Ford, Hon. Harold E., a Representative in Congress from the State of Tennesses, statement and attachment 849
General Motors Corp., statement 2014
Geoghegan, William A., Association of Financial Guaranty Insurers, statement and attachments 1837
Georgine, Robert A., Building and Construction Trades Department, AFL-CIO, statement 1921
Godwin, Jean C., American Association of Port Authorities, letter 2146
Goff, Charles F., Destec Energy, Inc., Houston, Tex., statement 2040
Goldbelt Corp., joint statement (*see listing for* Arctic Slope Regional Corp.)
Goodman, Craig G., Mitchell Energy & Development Corp., The Woodlands, Tex., letter and attachment 2059
Griffin Industries, Inc., Cold Spring, Ky., Dennis B. Griffin, statement 1864
Harcar, Mary V., Canadian Life and Health Insurance Association, statement 1826
Hardel Mutual Plywood Corp., joint statement (*see listing for* Delson Lumber Co.)
Harper, H. Mitchell, Texas Commerce Investment Co., Houston, Tex., letter ... 1818
Harrington, Carol A., Kathryn G. Henkel, Carlyn S. McCaffrey, Lloyd Leva Plaine, and Pam H. Schneider, American Bar Association, Real Property, Probate & Trust Section, joint letter 2201
Harsch Investment Corp., Portland Ore., Harold and Arlene Schnitzer, statement 2160
Hastings, Barry G., Northern Trust Co., Chicago, Ill., letter 1815
Hawaiian Trust Co., Ltd., Honolulu, Hawaii, Douglas Philpotts, letter 1807
Hawkins, Charles E., III, Associated Builders and Contractors, Inc., letter 1919
Heffelfinger, Rich, Independent Oil and Gas Association of West Virginia, statement 2044
Henkel, Kathryn G., American Bar Association, Real Property, Probate & Trust Section, joint letter (*see listing for* Carol A. Harrington)
Herman, Michael E., Kansas City Royals Baseball, statement 1385
Hobart, Larry, American Public Power Association; National Rural Electric Cooperative Association, Bob Bergland; and National Association of Regulatory Utility Commissioners, Thomas Choman, joint letter 2095
Hobart, Larry, American Public Power Association, statement 2133
Hocker, Jean W., Land Trust Alliance, statement 1948
Hynes, Timothy J., III, Security Trust Co., N.A., Baltimore, Md., letter 1817
Illinois Supreme Court, Hon. Benjamin K. Miller, Chief Justice, letter and attachment 1893
Independent Bankers Association of America, James R. Lauffer, statement 1809
Independent Oil and Gas Association of West Virginia, Rich Heffelfinger, statement 2044

Page
Independent Petroleum Association of America, Roy W. Willis, letter 2080
Information Tecnology Association of America, Luanne James, statement 1984
Investment Co. Institute, statement 2211
J&B Management Co., Fort Lee, N.J., Bernard Rodin, statement 2110
James, Luanne, Information Tecnology Association of America, statement 1984
Jenner, Gregory F., and Ronald L. Platt, McDermott, Will & Emery, Washington, D.C., statement 1958
Johnson, Hon. Nancy L., a Representative in Congress from the State of Connecticut:
  Statement 609
  Statement 851
Johnson, Peter, Caribbean Latin American Action, letter 2009
Kanjorski, Hon. Paul E., a Representative in Congress from the State of Pennsylvania, statement 2162
Kansas City Royals Baseball, Michael E. Herman, statement 1385
Keeling, J. Michael, ESOP Association, statement 1906
Kenetech/U.S. Windpower, Robert T. Boyd, statement 2088
Kennelly, Hon. Barbara B., a Representative in Congress from the State of Connecticut, statement 2219
Kirkmire, Nicholas J., Washington Citizens for World Trade, Olympia, Wash., statement 2093
Kleczka, Gerald D., a Representative in Congress from the State of Wisconsin, statement 2131
Koncor Forest Products Co., Anchorage, Alaska, John Sturgeon, statement 2155
KPMG Peat Marwick, New York, N.Y., Kathy L. Anderson, letter 1811
Kuehne, M.J. “Gus”, Northwest Independent Forest Manufacturers, Tacoma, Wash., statement and attachment 2036
Lackritz, Marc E., Securities Industry Association, statement 1823
Ladner, H.P. “Pat”, Alaska Aerospace Development Corp., Anchorage, Alaska, statement 2114
Land Trust Alliance, Jean W. Hocker, statement 1948
Large Public Power Council, Phoenix, Ariz., Mark Bonsall, statement 2085
Lauffer, James R., Independent Bankers Association of America, statement 1809
LeBoeuf, Raymond W., PPG Industries, Inc., statement 1911
Lederer, Rob, National Staff Leasing Association, letter 2186
Leszinske, William O., Texas Commerce Investment Co., Houston, Tex., letter 1819
Lewis, Raymond A., American Methanol Institute, statement 2069
Liberatore, Robert G., Chrysler Corp., statement and attachment 1902
Lockhart, James H., Baptist Foundation of Oklahoma, statement 1931
Loree, Philip J., Federation of American Controlled Shipping, statement 1987
Los Angeles, Calif., City of, statement 2083
Lottes, John W., Art Institute of Southern California, Laguna Beach, Calif., letter 2159
Louisiana Land & Exploration Co., New Orleans, La., Leighton Steward, statement 2054
Lovin, Keith, Maryville University, St. Louis, Mo., letter 2206
Lowey, Hon. Nita M., a Representative in Congress from the State of New York, statement 2109
Lozano, Joseph J., Construction Financial Management Association, statement 1924
Luna, Hon. Casey, Lt. Governor, State of New Mexico, statement 2115
Magna Trust Co., Belleville, Ill., Peter C. Merzian, letter 1812
Mahlik, Michael B., Associated Bank, N.A, Neenah, Wis., letter 1792
Manke Lumber Co., joint statement (*see listing for* Delson Lumber Co.) 2034
Maryville University, St. Louis, Mo., Keith Lovin, letter 2206
Massachusetts Municipal Wholesale Electric Co., statement 2140
Matsui, Hon. Robert T., a Representative in Congress from the State of California:
  Statement 674
  Statement 730
  Statement 853
  Statement 855
Mauro, Garry, Texas Veterans Land Board, Austin, Tex., statement 2118
McCaffrey, Caryln S., American Bar Association, Real Property, Probate & Trust Section, joint letter (*see listing for* Carol A. Harrington)
McClure, Trotter & Mentz, Chtd., Washington, D.C., William P. McClure, statement 2023

Page
McNeill, Robert L., Emergency Committee for American Trade, letter 1975
McPhail, Robert L., Basin Electric Power Cooperative, Bismark, N.Dak., statement 2180
MDU Resources Group, Inc., Bismark, N.Dak., Robert E. Wood, statement 2057
Melville, Jennifer, Appalachian Mountain Club, Boston, Mass., statement 1942
Meridian Asset Management, Inc., Valley Forge, Pa., Robert C. Williams, letter 1813
Merzian, Peter C., Magna Trust Co., Belleville, Ill., letter 1812
Midlantic National Bank, Edison, N.J., A.J. DiMatties, letter 1814
Military Coalition, Michael Ouelette and Paul W. Arcari, letter 1929
Miller, Hon. Benjamin K., Chief Justice, Illinois Supreme Court, letter and attachment 1893
Mitchell Energy & Development Corp., The Woodlands, Tex., Craig G. Goodman, letter and attachment 2059
Moakley, Hon. John Joseph, a Representative in Congress from the State of Massachusetts, statement 2196
Murphy, John M., Jr., First Trust National Association, St. Paul, Minn., letter 1805
Mutual of America, Daniel W. Coyne, letter 1836
Myers, Robert J., Silver Spring, Md., statement 2195
National Association for the Self-Employed, Bennie L. Thayer, letter 2221
National Association of Bond Lawyers, statement 2141
National Association of Independent Colleges and Universities; American Council on Education; and National Association of State Universities and Land Grant Colleges, Richard F. Rosser, joint letter 2124
National Association of Regulatory Utililty Commissioners:
  Thomas Choman, joint letter (*see listing for* American Public Power Association)
  Linda Bisson Stevens, letter and attachments 1787
National Association of State Universities and Land Grant Colleges, Richard F. Rosser, joint letter (*see listing for* National Association of Independent Colleges and Universities)
National Cooperative Business Center, Russell C. Notar, statement 2102
National Foreign Trade Council, Inc., statement 1976
National Presto Industries, Inc., Eau Claire, Wis., Joseph H. Berney, statement 2183
National Rural Electric Cooperative Association, Bob Bergland:
  Joint letter (*see listing for* American Public Power Association)
  Statement 718
  Statement 1871
National Staff Leasing Association, Rob Lederer, letter 2186
Natural Resources Defense Council, Marika Tatsutani, statement 2084
Neal, Hon. Richard E., a Representative in Congress from the State of Massachusetts, statement 2197
New Mexico, State of, Hon. Casey Luna, Lt. Governor, statement 2115
New York, City of, Hon. David N. Dinkins, Mayor, statement 2223
New York Cruise Lines, Inc., August J. Ceradini, Jr., letter 1879
New York, State of, Vincent Tese, statement 2176
Non Commissioned Officers Association of the United States of America, Larry D. Rhea and Michael F. Ouelette, statement 1913
Northeast Public Power Association, Westborough, Mass., statement 2230
Northern Trust Co., Chicago, Ill., Barry G. Hastings, letter 1815
Northwest Independent Forest Manufacturers, Tacoma, Wash., M.J. "Gus" Kuehne, statement and attachment 2036
Notar, Russell C., National Cooperative Business Center, statement 2102
Novack, Kenneth M., Schnitzer Investment Corp., Portland, Ore., statement 1866
O'Hare, Dean R., Chubb Corp., Warren, N.J., statement 1970
Old Kent Bank and Trust Co., Grand Rapids, Mich., E. Philip Farley, letter 1816
Oregon Trout, Inc., Portland, Ore., Geoff Pampush, letter 1950
Ortiz, Richard L., Shoshone and Arapaho Tribes' Joint Business Council, Fort Washakie, Wyo., letter and attachment 2148
Ouelette, Michael:
  Military Coalition, letter 1929
  Non Commissioned Officers Association of the United States of America, statement 1913
PacifiCorp Financial Services, Portland, Ore., William E. Peressini, statement 2098
Pampush, Geoff, Oregon Trout, Inc., Portland, Ore., letter 1950

Page
Passenger Vessel Association, Eric G. Scharf, letter 1880
Pendergrass, James D., Western Farmers Electric Cooperative, Anadarko, Okla., statement 2165
Peressini, William E., PacifiCorp Financial Services, Portland, Ore., statement 2098
Perkinson, Gary J., Beneficial Corp., statement 2012
Perlman, Robert H., Tax Executives Institute, Inc., letter 1981
Petersdorf, M.D., Robert G., Association of American Medical Colleges, letter 2193
Phillips, John J., First Fidelity Bank, N.A., New Jersey, letter 1799
Philpotts, Douglas, Hawaiian Trust Co., Ltd., Honolulu, Hawaii, letter 1807
Plaine, Lloyd Leva, American Bar Association, Real Property, Probate & Trust Section, joint letter (*see listing for* Carol A. Harrington)
Platt, Ronald L., and Gregory F. Jenner, McDermott, Will & Emery, Washington, D.C., statement 1958
Platt, Ronald L., Southland Corp., Dallas, Tex., statement 2171
PPG Industries, Inc., Raymond W. LeBoeuf, statement 1911
Quaal, Ward L., Ward L. Quaal Co., statement 1954
Quinn, Carol A., and Irving Salem, Latham & Watkins, New York, N.Y., statement 2104
Rahall, Hon. Nick J., II, a Representative in Congress from the State of West Virginia, statement 1890
Rhea, Larry D., Non Commissioned Officers Association of the United States of America, statement 1913
Robertson, Steve A., American Legion, statement 1887
Rodin, Bernard, J&B Management Co., Fort Lee, N.J., statement 2110
Rosser, Richard F., National Association of Independent Colleges and Universities; American Council on Education; and National Association of State Universities and Land Grant Colleges, joint letter 2124
Roundtree, Robert E., City Utilities of Springfield, Mo., letter (forwarded by the Hon. Mel Hancock, a Representative in Congress from the State of Missouri) 2074
Rozycki, Robert C., Federal-Mogul Corp., Detroit, Mich., statement 2019
Sacramento, Calif., Municipal Utility District, statement 2096
Salem, Irving, and Carol A. Quinn, Latham & Watkins, New York, N.Y., statement 2104
Salt River Project of Phoenix, Ariz., Mark Bonsall, statement 2085
Save the Bay, Providence, R.I., Curt Spalding, letter 1951
Savings Bank Life Insurance Co., Woburn, Mass., Robert K. Sheridan, statement 1820
Sayville Ferry, Sayville, N.Y., Ken Stein, Jr., letter 1882
Scharf, Eric G., Passenger Vessel Association, letter 1880
Schneider, Pam H., American Bar Association, Real Property, Probate & Trust Section, joint letter (*see listing for* Carol A. Harrington)
Schnitzer, Harold and Arlene, Harsch Investment Corp., Portland Ore., statement 2160
Schnitzer Investment Corp., Portland, Ore., Kenneth M. Novack, statement 1866
Sealaska Corp., joint statement (*see listing for* Arctic Slope Regional Corp.)
Securities Industry Association, Marc E. Lackritz, statement 1823
Security Trust Co., N.A., Baltimore, Md., Timothy J. Hynes III, letter 1817
Shaw, Hon. E. Clay, Jr., a Representative in Congress from the State of Florida, statement 1996
Sheridan, Robert K., Savings Bank Life Insurance Co., Woburn, Mass., statement 1820
Shoshone and Arapaho Tribes' Joint Business Council, Fort Washakie, Wyo., Richard L. Ortiz, letter and attachment 2148
Sierra Semiconductor Corp., James V. Diller, statement and attachments 2187
Sinaikin, Ronald A., AlliedSignal Inc., statement 1908
Solo Cup Co., statement 1859
South Carolina Coastal Conservation League, Charleston, S.C., Dana Beach, statement 1952
Southern California Public Power Authority, Pasadena, Calif., statement 2086
Southland Corp., Dallas, Tex., Ronald L. Platt, statement 2171
Spalding, Curt, Save the Bay, Providence, R.I., letter 1951
Stanford University, Stanford, Calif., Peter Van Etten, statement 2122
Startzell, David N., Appalachian Trail Conference, Harpers Ferry, W.Va., statement 1943
Stein, Ken, Jr., Sayville Ferry, Sayville, N.Y., letter 1882
Stern, Ira, Dutchess Land Conservancy, Stanfordville, N.Y., statement 1947

Page
Stevens, Linda Bisson, National Association of Regulatory Utility Commissioners, letter and attachments 1787
Steward, Leighton, Louisiana Land & Exploration Co., New Orleans, La., statement 2054
Stier, Daniel D., Wisconsin Department of Veterans Affairs, letter 2119
Stokes, John, Appalachian Trail Conference, Harpers Ferry, W.Va., statement 1943
Stump, Hon. Bob, a Representative in Congress from the State of Arizona, letter and attachment 1892
Sturgeon, John, Koncor Forest Products Co., Anchorage, Alaska, statement 2155
Suggs, Hon. Joseph M., Jr., Connecticut, State of, statement 2127
Sweeney, Hon. William W., Bedford County (Va.) Circuit Court, letter (forwarded by the Hon. L.F. Payne, a Representative in Congress from the State of Virginia) 1896
Tampa (Fla.) Electric Co., statement 2042
Tatsutani, Marika, Natural Resources Defense Council, statement 2084
Tax Executives Institute, Inc., Robert H. Perlman, letter 1981
Tese, Vincent, State of New York, statement 2176
Texas Commerce Investment Co., Houston, Tex.:
  H. Mitchell Harper, letter 1818
  William O. Leszinske, letter 1819
Texas Veterans Land Board, Austin, Tex., Garry Mauro, statement 2118
Thayer, Bennie L., National Association for the Self-Employed, letter 2221
Traba, Michael P., First National Bank of Chicago, statement 1801
Trapp, James M., American College of Trust and Estate Counsel, letter 2198
University of Arkansas, Fayetteville, Ark., A.H. Edwards, letter 2208
Updike, Lawrence C., Alcoma Association, Inc., Lake Wales, Fla., statement ... 1858
Uravic, Ed, Allegheny Electric Cooperative, Inc., Harrisburg, Pa., letter 2178
USX Corp., statement 2091
Van Etten, Peter, Stanford University, Stanford, Calif., statement 2122
Ward L. Quaal Co., Ward L. Quaal, statement 1954
Washington Citizens for World Trade, Olympia, Wash., Nicholas J. Kirkmire, statement 2093
Wells Manufacturing Co., statement 1862
Western Farmers Electric Cooperative, Anadarko, Okla., James D. Pendergrass, statement 2165
Weymouth, George A., Brandywine Conservancy, Chadds Ford, Pa., statement 1945
Whillock, Carl S., Arkansas Electric Cooperative Corp., letter 1870
Williams, Robert C., Jr., Columbia Gas Development Corp., Houston, Tex., statement 2050
Williams, Robert C., Meridian Asset Management, Inc., Valley Forge, Pa., letter 1813
Williamson, Robert D., American Society for Payroll Management, statement . 1917
Willis, Roy W., Independent Petroleum Association of America, letter 2080
Wisconsin Department of Veterans Affairs, Daniel D. Stier, letter 2119
Wise, Hon. Bob, a Representative in Congress from the State of West Virginia, letter and attachments 2045
Wood, Robert E., MDU Resources Group, Inc., Bismark, N.Dak., statement 2057
Worthy, K. Martin, Hopkins & Sutter, Washington, D.C., statement 611
Young, J. Blake, Jr., Bank South, N.A., Atlanta, Ga., letter 1796

LISTING BY SUBJECT—REVENUE RAISERS

GENERAL

Business Roundtable, statement 2233
National Society of Public Accountants, Leroy A. Strubberg, and Jeffrey A. Lear, statement 2235

ALTERNATIVE MINIMUM TAX

American Forest and Paper Association, statement (*see listing under* Multiple Issues heading)
Coal Tax Committee, statement 2240
National Coal Association, Richard L. Lawson, statement 2237

Page

ACCOUNTING

American Bankers Association, statement (*see listing under* Multiple Issues heading)
American Electronics Association, statement (*see listing under* Multiple Issues heading)
American Forest and Paper Association, statement (*see listing under* Multiple Issues heading)
American Trucking Associations, Inc., statement (*see listing under* Multiple Issues heading)
Barth, James P., North Bend, Ohio, letter 2243
Black Entertainment Television, Robert L. Johnson, letter 2244
Burt, R.L., Southampton, Mass., letter (*see listing under* Multiple Issues heading)
Center for the Study of Commercialism, Michael F. Jacobson, letter 2245
Centex Corp., Dallas, Tex., Richard C. Harvey, letter (*see listing under* Multiple Issues heading)
Danaher Corp., Washington, D.C., James H. Ditkoff, letter and attachment 2249
Edwin L. Cox Co., Dallas, Tex., J. Oliver McGonigle, letter 2251
Fisher, John J., Barrington, Ill., letter 2252
Food Marketing Institute, and International Mass Retail Association, joint statement 2253
Larsen, Bryant & Porter, CPA'S, P.C., Lincoln, Neb., Brent L. Stehlik, letter (*see listing under* Multiple Issues heading)
Mattel, Inc., statement 2255
Miles Inc., Pittsburgh, Pa., Helge H. Wehmeier, letter 2257
National Association of Enrolled Agents, James E. Forrester, statement (*see listing under* Multiple Issues heading)
National Association of Realtors, statement (*see listing under* Multiple Issues heading)
Ralston Purina Co., Ronald B. Weinel, statement and attachments 2258
Retail Tax Committee of Common Interest, statement 2263
Sundquist, Hon. Don, a Representative in Congress from the State of Tennessee, statement 2266
Tax Executives Institute, Inc., Ralph J. Weiland, statement (*see listing under* Multiple Issues heading)
True Companies, Casper, Wyo., statement (*see listing under* Multiple Issues heading)
United States Telephone Association, John Sodolski, statement (*see listing under* Multiple Issues heading)

FINANCIAL INSTITUTIONS

American Bankers Association, statement (*see listing under* Multiple Issues heading)
Centex Corp., Dallas, Tex., Richard C. Harvey, letter (*see listing under* Multiple Issues heading)
Fidelty Federal Bank, Glendale, Calif., Kathleen A. Christianson, letter 2267
KPMG Peat Marwick, statement 2268

COST RECOVERY

Kieffer-Nolde, Chicago, Ill., Neil J. Schecter, letter 2278
Laser Graphics, Inc., Hillside, Ill., Steve Giusti, letter 2279
National Association of Water Companies, James L. Good, statement 2274
Sundquist, Hon. Don, a Representative in Congress from the State of Tennessee, statement 2280
Techtron Imaging Centre, Chicago, Ill., Walter C. Pabst, letter 2281

Page

INDIVIDUAL INCOME TAX

American Greyhound Track Operators Association, Henry C. Cashen and John C. Dill, statement (*see listing under* Multiple Issues heading)
American Horse Council, Inc., statement (*see listing under* Multiple Issues heading)
American Trucking Associations, Inc., statement (*see listing under* Multiple Issues heading)
Bilbray, Hon. James H., a Representative in Congress from the State of Nevada, statement (*see listing under* Multiple Issues heading)
Bryan, Hon. Richard, a United States Senator from the State of Nevada, statement (*see listing under* Multiple Issues heading)
Burt, R.L., Southampton, Mass., letter (*see listing under* Multiple Issues heading)
Coopers & Lybrand, Washington, D.C., statement 2284
Customs Science Services, Inc., Kensington, Md., Roger J. Crain, letter 2283
Larsen, Bryant & Porter, CPA's, P.C., Lincoln, Neb., Brent L. Stehlik, letter (*see listing under* Multiple Issues heading)
National Association for the Self-Employed, Bennie L. Thayer, letter (*see listing under* Multiple Issues heading)
National Association of Enrolled Agents, James E. Forrester, statement (*see listing under* Multiple Issues heading)
National Association of Realtors, statement (*see listing under* Multiple Issues heading)
National Conference of State Social Security Administrators, Daryl Dunagan, letter (*see listing under* Multiple Issues heading)
Nevada Resort Association, David Belding, statement 2287
Reid, Hon. Harry, a United States Senator from the State of Nevada, statement (*see listing under* Multiple Issues heading)
SeaWest, San Diego, Calif., Thomas G. Farnham, letter 2290
Swavelle/Mill Creek Fabrics, New York, N.Y., Jeffrey B. Kraut, letter 2282
True Companies, Casper, Wyo., statement (*see listing under* Multiple Issues heading)
United States Telephone Association, John Sodolski, statement (*see listing under* Multiple Issues heading)
Vucanovich, Hon. Barbara F., a Representative in Congress from the State of Nevada, statement (*see listing under* Multiple Issues heading)

NATURAL RESOURCES

American Trucking Associations, Inc., statement (*see listing under* Multiple Issues heading)
Center for International Environmental Law, Robert F. Housman, statement . 2294
National Petroleum Refiners Association, Urvan R. Sternfels, letter 2298
Reid, Hon. Harry, a United States Senator from the State of Nevada, statement 2291
True Companies, Casper, Wyo., statement (*see listing under* Multiple Issues heading)

FOREIGN TAX PROVISIONS

American Bankers Association, statement (*see listing under* Multiple Issues heading)
American Electronics Association, statement (*see listing under* Multiple Issues heading)
American Federation of Labor and Congress of Industrial Organizations, Robert E. Lucore, statement 2325
American Forest and Paper Association, statement (*see listing under* Multiple Issues heading)
American Petroleum Institute, statement (*see listing under* Multiple Issues heading)
American Trucking Associations, Inc., statement (*see listing under* Multiple Issues heading)
Arthur Andersen & Co., Andre P. Fogarasi and Richard A. Gordon, statement 2329
Association of British Insurers, statement 2339
Attorneys' Liability Assurance Society, Inc., John E. Chapoton and Thomas A. Stout, Jr., letter 2345

Page
Danaher Corp., Washington, D.C., James H. Ditkoff, letter 2337
Export Source Coalition, Paul W. Oosterhuis and Roseann M. Cutrone, statement and attachments 2299
International Tax Policy Forum, Joel Slemrod, statement and attachment 2309
Kennelly, Hon. Barbara B., a Representative in Congress from the State of Connecticut, letter and attachments 2350
National Association of Insurance Brokers, Michael J. Hass, letter 2364
Organization for International Investment Inc., Alexander Spitzer, statement and attachments (*see listing under* Multiple Issues heading)
Public Securities Association, statement 2318
Reinsurance Association of America, statement 2366
Risk and Insurance Management Society, Inc., Paul S. Brown, letter 2374
Securities Industry Association, Marc E. Lackritz, statement 2320
Tax Executives Institute, Inc., Ralph J. Weiland, statement (*see listing under* Multiple Issues heading)
United States Council for International Business:
  Statement 2312
  Statement 2324
United States Telephone Association, John Sodolski, statement (*see listing under* Multiple Issues heading)
United Technologies, William F. Paul, letter 2316

EXCISE TAXES

American Forest and Paper Association, statement and attachment 2399
American Horse Council, Inc., statement (*see listing under* Multiple Issues heading)
American Trucking Associations, Inc., statement (*see listing under* Multiple Issues heading)
Asociacion de Exportadores De Chile (Chilean Exporter's Association), Ronald S. Bown F., letter and attachment 2402
Association of Home Appliance Manufacturers, statement 2407
Bilbray, Hon. James H., a Representative in Congress from the State of Nevada, statement (*see listing under* Multiple Issues heading)
Bryan, Hon. Richard, a United States Senator from the State of Nevada, statement (*see listing under* Multiple Issues heading)
Carrier Corp., Syracuse, N.Y., Edward A. Baily, letter 2409
Cetylite Industries, Inc., Pennsauken, N.J., Stanley L. Wachman, statement 2410
Mack Trucks, Inc., Mark Cherry, statement and attachments 2388
National Cable Television Association, Decker Anstrom, statement 2381
National Truck Equipment Association, Michael E. Kastner, letter and attachment 2396
Nevada Resort Association, David Belding, statement 2378
Newspaper Association of America, statement 2382
Organization for International Investment Inc., Alexander Spitzer, statement and attachments(*see listing under* Multiple Issues heading)
Polyisocyanurate Insulation Manufacturers Association, Jared O. Blum, statement 2412
Reid, Hon. Harry, a United States Senator from the State of Nevada, statement (*see listing under* Multiple Issues heading)
Renewable Fuels Association, Eric Vaughn, statement 2383
Society of the Plastics Industry, Inc., Maureen A. Healey, letters and attachments 2416
Tax Executives Institute, Inc., Ralph J. Weiland, statement (*see listing under* Multiple Issues heading)
Truck Trailer Manufacturers Association, Richard P. Bowling, letter 2398
True Companies, Casper, Wyo., statement (*see listing under* Multiple Issues heading)
United States Telephone Association, John Sodolski, statement (*see listing under* Multiple Issues heading)
Vucanovich, Hon. Barbara F., a Representative in Congress from the State of Nevada, statement (*see listing under* Multiple Issues heading)
Whirlpool Corp., Michael C. Thompson, statement 2421

TAX-EXEMPT ENTITIES

Alliance for Justice, Nan Aron and Carol Siefert, letter and attachment 2431
American Association of Museums, Edward H. Able, Jr., letter 2436

Page

American Gas Association, statement (*see listing under* Multiple Issues heading)
American Petroleum Institute, statement (*see listing under* Multiple Issues heading)
American Trucking Associations, Inc., statement (*see listing under* Multiple Issues heading)
Center for Non-Profit Corporations, Princeton, N.J., Linda M. Czipo, letter 2438
Independent Bankers Association of America, statement (*see listing under* Multiple Issues heading)
National Association of Convenience Stores, statement (*see listing under* Multiple Issues heading)
National Association of Realtors, statement (*see listing under* Multiple Issues heading)
National Club Association, statement 2423
National Panhellenic Conference, Harriett B. Macht; National Pan-Hellenic Council, Inc., Daisy Wood; and National Interfraternity Conference, Robert D. Lynd, joint statement and attachment 2426
National Venture Capital Association, Dean C. Gordanier, Jr., letter 2440
Tax Executives Institute, Inc., Ralph J. Weiland, statement (*see listing under* Multiple Issues heading)
True Companies, Casper, Wyo., statement (*see listing under* Multiple Issues heading)
United States Telephone Association, John Sodolski, statement (*see listing under* Multiple Issues heading)

COMPLIANCE

American Bankers Association, statement (*see listing under* Multiple Issues heading)
American Electronics Association, statement (*see listing under* Multiple Issues heading)
American Forest and Paper Association, statement (*see listing under* Multiple Issues heading)
American Gas Association, statement (*see listing under* Multiple Issues heading)
American Greyhound Track Operators Association, Henry C. Cashen and John C. Dill, statement (*see listing under* Multiple Issues heading)
American Horse Council, Inc., statement (*see listing under* Multiple Issues heading)
American Land Title Association, Ann vom Eigen, statement 2447
American Trucking Associations, Inc., statement (*see listing under* Multiple Issues heading)
Bilbray, Hon. James H., a Representative in Congress from the State of Nevada, statement (*see listing under* Multiple Issues heading)
Bryan, Hon. Richard, a United States Senator from the State of Nevada, statement (*see listing under* Multiple Issues heading)
Burt, R.L., Southampton, Mass., letter (*see listing under* Multiple Issues heading)
Coalition on Interest Disallowance, statement 2455
Federation of Tax Administrators, Harley T. Duncan, statement and attachment 2449
Gomola, Gary R., Coughlin & Gomola, Middletown, Conn., letter 2453
Independent Bankers Association of America, statement (*see listing under* Multiple Issues heading)
Larsen, Bryant & Porter, CPA's, P.C., Lincoln, Neb., Brent L. Stehlik, letter (*see listing under* Multiple Issues heading)
Levenson, Daniel D., Lourie & Cutler, P.C., Boston, Mass., statement 2461
National Association for the Self-Employed, Bennie L. Thayer, letter (*see listing under* Multiple Issues heading)
National Association of Convenience Stores, statement (*see listing under* Multiple Issues heading)
National Association of Enrolled Agents, James E. Forrester, statement (*see listing under* Multiple Issues heading)
National Conference of State Social Security Administrators, Daryl Dunagan, letter (*see listing under* Multiple Issues heading)
Nevada Resort Association, David Belding, statement 2458

Page

Reid, Hon. Harry, a United States Senator from the State of Nevada, statement (*see listing under* Multiple Issues heading)

Tax Executives Institute, Inc., Ralph J. Weiland, statement (*see listing under* Multiple Issues heading)

True Companies, Casper, Wyo., statement (*see listing under* Multiple Issues heading)

United States Telephone Association, John Sodolski, statement (*see listing under* Multiple Issues heading)

Vucanovich, Hon. Barbara F., a Representative in Congress from the State of Nevada, statement (*see listing under* Multiple Issues heading)

MISCELLANEOUS ISSUES

Alliance Exchange Group, Inc., Santa Ana, Calif., Deanna F. Burton, letter 2498

American Electronics Association, statement (*see listing under* Multiple Issues heading)

American Equity Exchange, Inc., Dillon, Mont., Max A. Hansen, letter 2499

American Forest and Paper Association, statement (*see listing under* Multiple Issues heading)

American Gas Association, statement (*see listing under* Multiple Issues heading)

American Land Title Association, Ann vom Eigen, statement 2500

American Petroleum Institute, statement (*see listing under* Multiple Issues heading)

American Trucking Associations, Inc., statement (*see listing under* Multiple Issues heading)

Bishop, Barbara, Pasedena, Calif., letter 2502

Building and Construction Trades Department, AFL-CIO, Robert A. Georgine, statement 2463

Coalition for Independent Contractors, Edward N. Delaney and Russell A. Hollrah, statement 2469

Environcol, James C. Godbout, Diane Herndon, and Mary Frances Pearson, statement 2513

Equity Advantage, Inc., Salem, Ore., Lonnie C. Nielson, Thomas N. Moore, and David S. Moore, letter 2503

Equity Reserve, Inc., Newport Beach, Calif., Frank C. Huntsman, letter 2504

Federation of Exchange Accommodators, Newport Beach, Calif., Andrew G. Potter, letter 2505

Hulen, Myron, Colorado State University; William Kinny, Portland State University; Jack Robison, California Polytechnic State University; and Michael Vaughan, Colorado State University, joint statement 2474

Independent Fuel Terminal Operators Association, statement and attachment 2518

International Council of Shopping Centers, Steven J. Guttman, statement 2507

Lantos, Hon. Tom, a Representative in Congress from the State of California, statement 1379

National Association for the Self-Employed, Bennie L. Thayer, letter (*see listing under* Multiple Issues heading)

National Association of Convenience Stores, statement (*see listing under* Multiple Issues heading)

National Association of Realtors, statement (*see listing under* Multiple Issues heading)

National Federation of Independent Business, statement 2482

New York Gas Group, Donald F. Straetz, statement 2523

Real Estate Exchange, Inc., Portland, Ore., James C. Casterline, letter 2510

Security Trust Co., San Diego, Calif., J. Paul Spring, letter 2512

Shays, Hon. Christopher, a Representative in Congress from the State of Connecticut, statement 1382

Stratford Technologies, Inc., Somerdale, N.J., William R. Patterson, letter 2490

Studds, Hon. Gerry E., a Representatives in Congress from the State of Massachusetts, statement 2497

Tax Executives Institute, Inc., Ralph J. Weiland, statement (*see listing under* Multiple Issues heading)

True Companies, Casper, Wyo., statement (*see listing under* Multiple Issues heading)

United Brotherhood of Carpenters and Joiners of America, AFL-CIO, statement 2492

Page

United States Telephone Association, John Sodolski, statement (*see listing under* Multiple Issues heading)

MULTIPLE ISSUES

American Bankers Association, statement 2525
American Electronics Association, statement 2529
American Forest and Paper Association, statement 2533
American Gas Association, statement 2535
American Greyhound Track Operators Association, Henry C. Cashen and John C. Dill, statement 2544
American Horse Council, Inc., statement 2546
American Petroleum Institute, statement 2551
American Trucking Associations, Inc., statement 2560
Bilbray, Hon. James H., a Representative in Congress from the State of Nevada, statement 2563
Bryan, Hon. Richard, a United States Senator from the State of Nevada, statement 2564
Burt, R.L., Southampton, Mass., letter 2566
Centex Corp., Dallas, Tex., Richard C. Harvey, letter 2567
Independent Bankers Association of America, statement 2568
Larsen, Bryant & Porter, CPA's, P.C., Lincoln, Neb., Brent L. Stehlik, letter 2570
National Association for the Self-Employed, Bennie L. Thayer, letter 2573
National Association of Convenience Stores, statement 2576
National Association of Enrolled Agents, James E. Forrester, statement 2580
National Association of Realtors, statement 2583
National Conference of State Social Security Administrators, Daryl Dunagan, letter 2587
Organization for International Investment Inc., Alexander Spitzer, statement and attachments 2589
Reid, Hon. Harry, a United States Senator from the State of Nevada, statement 2597
Tax Executives, Inc., Ralph J. Weiland, statement 2599
True Companies, Casper, Wyo., statement 2609
United States Telephone Association, John Sodolski, statement 2618
Vucanovich, Hon. Barbara F., a Representative in Congress from the State of Nevada, statement 2623

COMBINED LISTING BY NAME AND ORGANIZATIONS (RAISERS)

Able, Edward H., Jr., American Association of Museums, letter 2436
Alliance Exchange Group, Inc., Santa Ana, Calif., Deanna F. Burton, letter 2498
Alliance for Justice, Nan Aron and Carol Siefert, letter and attachment 2431
American Association of Museums, Edward H. Able, Jr., letter 2436
American Bankers Association, statement 2525
American Electronics Association, statement 2529
American Equity Exchange, Inc., Dillon, Mont., Max A. Hansen, letter 2499
American Federation of Labor and Congress of Industrial Organizations, Robert E. Lucore, statement 2325
American Forest and Paper Association:
  Statement and attachment 2399
  Statement 2533
American Gas Association, statement 2535
American Greyhound Track Operators Association, Henry C. Cashen and John C. Dill, statement 2544
American Horse Council, Inc., statement 2546
American Land Title Association, Ann vom Eigen:
  Statement 2447
  Statement 2500
American Petroleum Institute, statement 2551
American Trucking Associations, Inc., statement 2560
Anstrom, Decker, National Cable Television Association, statement 2381
Aron, Nan, Alliance for Justice, letter and attachment 2431
Arthur Andersen & Co., Andre P. Fogarasi and Richard A. Gordon, statement 2329
Asociacion de Exportadores De Chile (Chilean Exporter's Association), Ronald S. Bown F., letter and attachment 2402
Association of British Insurers, statement 2339

Page
Association of Home Appliance Manufacturers, statement 2407
Attorneys' Liability Assurance Society, Inc., John E. Chapoton and Thomas A. Stout, Jr., letter 2345
Baily, Edward A., Carrier Corp., Syracuse, N.Y., letter 2409
Barth, James P., North Bend, Ohio, letter 2243
Belding, David, Nevada Resort Association:
  Statement 2287
  Statement 2378
  Statement 2458
Bilbray, Hon. James H., a Representative in Congress from the State of Nevada, statement 2563
Bishop, Barbara, Pasedena, Calif., letter 2502
Black Entertainment Television, Robert L. Johnson, letter 2244
Blum, Jared O., Polyisocyanurate Insulation Manufacturers Association, statement 2412
Bowling, Richard P., Truck Trailer Manufacturers Association, letter 2398
Bown F., Ronald S., Asociacion de Exportadores De Chile (Chilean Exporter's Association), letter and attachment 2402
Brown, Paul S., Risk and Insurance Management Society, Inc., letter 2374
Bryan, Hon. Richard, a United States Senator from the State of Nevada, statement 2564
Building and Construction Trades Department, AFL-CIO, Robert A. Georgine, statement 2463
Burt, R.L., Southampton, Mass., letter 2566
Burton, Deanna F., Alliance Exchange Group, Inc., Santa Ana, Calif., letter 2498
Business Roundtable, statement 2233
Carrier Corp., Syracuse, N.Y., Edward A. Baily, letter 2409
Cashen, Henry C., American Greyhound Track Operators Association, statement 2544
Casterline, James C., Real Estate Exchange, Inc., Portland, Ore., letter 2510
Center for International Environmental Law, Robert F. Housman, statement 2294
Center for Non-Profit Corporations, Princeton, N.J., Linda M. Czipo, letter 2438
Center for the Study of Commercialism, Michael F. Jacobson, letter 2245
Centex Corp., Dallas, Tex., Richard C. Harvey, letter 2567
Cetylite Industries, Inc., Pennsauken, N.J., Stanley L. Wachman, statement 2410
Chapoton, John E., Attorneys' Liability Assurance Society, Inc., letter 2345
Cherry, Mark, Mack Trucks, Inc., statement and attachments 2388
Christianson, Kathleen A., Fidelty Federal Bank, Glendale, Calif., letter 2267
Coal Tax Committee, statement 2240
Coalition for Independent Contractors, Edward N. Delaney and Russell A. Hollrah, statement 2469
Coalition on Interest Disallowance, statement 2455
Coopers & Lybrand, Washington, D.C., statement 2284
Customs Science Services, Inc., Kensington, Md., Robert J. Crain, letter 2283
Cutrone, Roseann M., Export Source Coalition, statement and attachments 2299
Czipo, Linda M., Center for Non-Profit Corporations, Princeton, N.J., letter 2438
Danaher Corp., Washington, D.C., James H. Ditkoff:
  Letter 2249
  Letter 2337
Delaney, Edward N., Coalition for Independent Contractors, statement 2469
Dill, John C., American Greyhound Track Operators Association, statement 2544
Ditkoff, James H., Danaher Corp., Washington, D.C.:
  Letter 2249
  Letter 2337
Dunagan, Daryl, National Conference of State Social Security Administrators, letter 2587
Duncan, Harley T., Federation of Tax Administrators, statement and attachment 2449
Edwin L. Cox Co., Dallas, Tex., J. Oliver McGonigle, letter 2251
Environcol, James C. Godbout, Diane Herndon, and Mary Frances Pearson, statement 2513
Equity Advantage, Inc., Salem, Ore., Lonnie C. Nielson, Thomas N. Moore, and David S. Moore, letter 2503
Equity Reserve, Inc., Newport Beach, Calif., Frank C. Huntsman, letter 2504
Export Source Coalition, Paul W. Oosterhuis and Roseann M. Cutrone, statement and attachments 2299
Farnham, Thomas G., SeaWest, San Diego, Calif., letter 2290

Page
Federation of Exchange Accommodators, Newport Beach, Calif., Andrew G. Potter, letter ... 2505
Federation of Tax Administrators, Harley T. Duncan, statement and attachment ... 2449
Fidelty Federal Bank, Glendale, Calif., Kathleen A. Christianson, letter ... 2267
Fisher, John J., Barrington, Ill., letter ... 2252
Fogarasi, Andre P., Arthur Andersen & Co., statement ... 2329
Food Marketing Institute, and International Mass Retail Association, joint statement ... 2253
Forrester, James E., National Association of Enrolled Agents, statement ... 2580
Georgine, Robert A., Building and Construction Trades Department, AFL-CIO, statement ... 2463
Giusti, Steve, Laser Graphics, Inc., Hillside, Ill., letter ... 2279
Godbout, James C., Environcol, statement ... 2513
Gomola, Gary R., Coughlin & Gomola, Middletown, Conn., letter ... 2453
Good, James L., National Association of Water Companies, statement ... 2274
Gordanier, Dean C., Jr., National Venture Capital Association, letter ... 2440
Gordon, Richard A., Arthur Andersen & Co., statement ... 2329
Guttman, Steven J., International Council of Shopping Centers, statement ... 2507
Hansen, Max A., American Equity Exchange, Inc., Dillon, Mont., letter ... 2499
Harvey, Richard C., Centex Corp., Dallas, Tex., letter ... 2567
Hass, Michael J., National Association of Insurance Brokers, letter ... 2364
Healey, Maureen A., Society of the Plastics Industry, Inc., letters and attachments ... 2416
Herndon, Diane, Environcol, statement ... 2513
Hollrah, Russell A., Coalition for Independent Contractors, statement ... 2469
Housman, Robert F., Center for International Environmental Law, statement 2294
Hulen, Myron, Colorado State University; William Kinny, Portland State University; Jack Robison, California Polytechnic State University; and Michael Vaughan, Colorado State University, joint statement ... 2474
Huntsman, Frank C., Equity Reserve, Inc., Newport Beach, Calif., letter ... 2504
Independent Bankers Association of America, statement ... 2568
Independent Fuel Terminal Operators Association, statement and attachment ... 2518
International Council of Shopping Centers, Steven J. Guttman, statement ... 2507
International Mass Retail Association, and Food Marketing Institute, joint statement ... 2253
International Tax Policy Forum, Joel Slemrod, statement and attachment ... 2309
Jacobson, Michael F., Center for the Study of Commercialism, letter ... 2245
Johnson, Robert L., Black Entertainment Television, letter ... 2244
Kastner, Michael E., National Truck Equipment Association, letter and attachment ... 2396
Kennelly, Hon. Barbara B., a Representative in Congress from the State of Connecticut, letter and attachments ... 2350
Kieffer-Nolde, Chicago, Ill., Neil J. Schecter, letter ... 2278
Kinny, William, Portland State University, joint statement (*see listing for* Myron Hulen)
KPMG Peat Marwick, statement ... 2268
Kraut, Jeffrey B., Swavelle/Mill Creek Fabrics, New York, N.Y., letter ... 2282
Lackritz, Marc E., Securities Industry Association, statement ... 2320
Lantos, Hon. Tom, a Representative in Congress from the State of California, statement ... 1379
Larsen, Bryant & Porter, CPA's, P.C., Lincoln, Neb., Brent L. Stehlik, letter .. 2570
Laser Graphics, Inc., Hillside, Ill., Steve Giusti, letter ... 2279
Lawson, Richard L., National Coal Association, statement ... 2237
Lear, Jeffrey A., National Society of Public Accountants, statement ... 2235
Levenson, Daniel D., Lourie & Cutler, P.C., Boston, Mass., statement ... 2461
Lucore, Robert E., American Federation of Labor and Congress of Industrial Organizations, statement ... 2325
Lynd, Robert D., National Interfraternity Conference, joint statement and attachment (*see listing for* National Panhellenic Conference)
Macht, Harriett B., National Panhellenic Conference, joint statement and attachment ... 2426
Mack Trucks, Inc., Mark Cherry, statement and attachments ... 2388
Mattel, Inc., statement ... 2255
McGonigle, J. Oliver, Edwin L. Cox Co., Dallas, Tex., letter ... 2251
Miles Inc., Pittsburgh, Pa., Helge H. Wehmeier, letter ... 2257
Moore, David S., Equity Advantage, Inc., Salem, Ore., letter ... 2503

Page

Moore, Thomas N., Equity Advantage, Inc., Salem, Ore., letter 2503
National Association for the Self-Employed, Bennie L. Thayer, letter 2573
National Association of Convenience Stores, statement 2576
National Association of Enrolled Agents, James E. Forrester, statement 2580
National Association of Insurance Brokers, Michael J. Hass, letter 2364
National Association of Realtors, statement 2583
National Association of Water Companies, James L. Good, statement 2274
National Cable Television Association, Decker Anstrom, statement 2381
National Club Association, statement 2423
National Coal Association, Richard L. Lawson, statement 2237
National Conference of State Social Security Administrators, Daryl Dunagan, letter 2587
National Federation of Independent Business, statement 2482
National Panhellenic Conference, Harriett B. Macht; National Pan-Hellenic Council, Inc., Daisy Wood; and National Interfraternity Conference, Robert D. Lynd, joint statement and attachment 2426
National Petroleum Refiners Association, Urvan R. Sternfels, letter 2298
National Society of Public Accountants, Leroy A. Strubberg, and Jeffrey A. Lear, statement 2235
National Truck Equipment Association, Michael E. Kastner, letter and attachment 2396
National Venture Capital Association, Dean C. Gordanier, Jr., letter 2440
Nevada Resort Association, David Belding:
  Statement 2287
  Statement 2378
  Statement 2458
New York Gas Group, Donald F. Straetz, statement 2523
Newspaper Association of America, statement 2382
Nielson, Lonnie C., Equity Advantage, Inc., Salem, Ore., letter 2503
Oosterhuis, Paul W., Export Source Coalition, statement and attachments 2299
Organization for International Investment Inc., Alexander Spitzer, statement and attachments 2589
Pabst, Walter C., Techtron Imaging Centre, Chicago, Ill., letter 2281
Patterson, William R., Stratford Technologies, Inc., Somerdale, N.J., letter 2490
Paul, William F., United Technologies, letter 2316
Pearson, Mary Frances, Environcol, statement 2513
Polyisocyanurate Insulation Manufacturers Association, Jared O. Blum, statement 2412
Potter, Andrew G., Federation of Exchange Accommodators, Newport Beach, Calif., letter 2505
Public Securities Association, statement 2318
Ralston Purina Co., Ronald B. Weinel, statement and attachments 2258
Real Estate Exchange, Inc., Portland, Ore., James C. Casterline, letter 2510
Reid, Hon. Harry, a United States Senator from the State of Nevada:
  Statement 2291
  Statement 2597
Reinsurance Association of America, statement 2366
Renewable Fuels Association, Eric Vaughn, statement 2383
Retail Tax Committee of Common Interest, statement 2263
Risk and Insurance Management Society, Inc., Paul S. Brown, letter 2374
Robison, Jack, California Polytechnic State University, joint statement (*see listing for* Myron Hulen)
Schecter, Neil J., Kieffer-Nolde, Chicago, Ill., letter 2278
SeaWest, San Diego, Calif., Thomas G. Farnham, letter 2290
Securities Industry Association, Marc E. Lackritz, statement 2320
Security Trust Co., San Diego, Calif., J. Paul Spring, letter 2512
Shays, Hon. Christopher, a Representative in Congress from the State of Connecticut, statement 1382
Siefert, Carol, Alliance for Justice, letter and attachment 2431
Slemrod, Joel, International Tax Policy Forum, statement and attachment 2309
Society of the Plastics Industry, Inc., Maureen A. Healey, letters and attachments 2416
Sodolski, John, United States Telephone Association, statement 2618
Spitzer, Alexander, Organization for International Investment Inc., statement and attachments 2589
Spring, J. Paul, Security Trust Co., San Diego, Calif., letter 2512
Stehlik, Brent L., Larsen, Bryant & Porter, CPA's, P.C., Lincoln, Neb., letter . 2570
Sternfels, Urvan R., National Petroleum Refiners Association, letter 2298

Page
Stout, Thomas A., Jr., Attorneys' Liability Assurance Society, Inc., letter 2345
Straetz, Donald F., New York Gas Group, statement 2523
Stratford Technologies, Inc., Somerdale, N.J., William R. Patterson, letter 2490
Strubberg, Leroy A., National Society of Public Accountants, statement 2235
Studds, Hon. Gerry E., a Representative in Congress from the State of Massachusetts, statement 2497
Sundquist, Hon. Don, a Representative in Congress from the State of Tennessee:
  Statement 2266
  Statement 2280
Swavelle/Mill Creek Fabrics, New York, N.Y., Jeffrey B. Kraut, letter 2282
Tax Executives Institute, Inc., Ralph J. Weiland, statement 2599
Techtron Imaging Centre, Chicago, Ill., Walter C. Pabst, letter 2281
Thayer, Bennie L., National Association for the Self-Employed, letter 2573
Thompson, Michael C., Whirlpool Corp., statement 2421
Truck Trailer Manufacturers Association, Richard P. Bowling, letter 2398
True Companies, Casper, Wyo., statement 2609
United Brotherhood of Carpenters and Joiners of America, AFL-CIO, statement 2492
United States Council for International Business:
  Statement 2312
  Statement 2324
United States Telephone Association, John Sodolski, statement 2618
United Technologies, William F. Paul, letter 2316
Vaughan, Michael, Colorado State University, joint statement (*see listing for* Myron Hulen)
Vaughn, Eric, Renewable Fuels Association, statement 2383
vom Eigen, Ann, American Land Title Association, statement 2500
Vucanovich, Hon. Barbara F., a Representative in Congress from the State of Nevada, statement 2623
Wachman, Stanley L., Cetylite Industries, Inc., Pennsauken, N.J., statement . 2410
Wehmeier, Helge H., Miles Inc., Pittsburgh, Pa., letter 2257
Weiland, Ralph J., Tax Executives Institute, Inc., statement 2599
Weinel, Ronald B., Ralston Purina Co., statement and attachments 2258
Whirlpool Corp., Michael C. Thompson, statement 2421
Wood, Daisy, National Pan-Hellenic Council, Inc., joint statement and attachment (*see listing for* National Panhellenic Conference)

MISCELLANEOUS REVENUE ISSUES

WEDNESDAY, SEPTEMBER 8, 1993

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:05 a.m., in room 1100, Longworth House Office Building, Hon. Charles B. Rangel (chairman of the subcommittee) presiding.

Chairman Rangel. Good morning.

The Subcommittee on Select Revenue Measures will resume its series of hearings on miscellaneous revenue issues. Earlier this year, we conducted four hearings focused on these matters. All of those were the revenue-losing issues. We will consider additional testimony today on other miscellaneous items. This time we will concentrate on those issues that raise revenue.

As those of you who are familiar with the committee are aware, Chairman Rostenkowski and our committee have a strong commitment to deficit reduction and responsible fiscal policy. In keeping with long tradition, any miscellaneous issue that the committee brings up, the member must offset it by an appropriate revenue-raising item. So we have to do both, raise the issue and find out how we are going to pay for it. Those suggested revenue raisers will be the subject of today's hearing and again on September 21 we will review or return to this issue.

We will hear from public witnesses in the following areas: the alternative minimum tax, accounting, financial institution costs, recovery pass-through entities, individual taxes, natural resources issue, and tax-exempt entities. On the second day of the hearings, Treasury is expected to testify on these issues, which will be September 21.

At this point, I would like to recognize the ranking member of the subcommittee, Mel Hancock for whatever opening remarks he has to make.

Mr. Hancock. Thank you, Mr. Chairman.

Today we will hear testimony from a wide variety of witnesses on a number of revenue-raising proposals before this subcommittee. As you remember, the committee spent several weeks this summer considering the revenue-losing provisions which constituted the easy part of the miscellaneous tax bill's journey through the Ways and Means Committee.

Many items discussed in the previous hearings made good sense and many should be enacted into law, but when you look at the list of revenue raisers we have before us today, and the additional items we will discuss later this month, one has to ask: Do the benefits derived from this process outweigh the burdens placed on individuals and businesses through the so-called revenue-raising offsets?

One merely has to look at this list of offsets to see that the burden on individuals and business will be great, in my opinion much greater than any benefits provided through this process. What is worse, these new tax proposals come 1 month after the President signed into law a new massive tax plan, which will affect nearly every individual and business in this country.

The effects of this process appear to be just as grave. Not only will these numerous provisions increase direct costs to individuals and businesses, the cost of complying with these complicated proposals could be astoundingly high. Limiting deductions, lengthening recovery periods, and stretching out amortization schedules are the methods of choice in raising this revenue.

Few of these proposals contain the characteristics of sound tax policy, and several make no sense at all. Many were conceived with no concern for their effect on those who will be impacted, but merely as a means to finance other provisions of the bill. In these times of slow economic growth and on the heels of the largest tax increase in history, we should not seriously be considering the items before us today.

While at first glance the items we will explore today may seem minor, let me assure you, Mr. Chairman, they are very important to those who will be affected and could hold disastrous economic consequences. I think it is some sort of dichotomy that yesterday the Vice President released an administration proposal to reinvent Government through consolidation and simplification. Now here we are today.

I encourage my colleagues on this panel to listen carefully to the witnesses who will testify before us, many of whom have already sacrificed under the President's tax bill. At the end of this long day, it should be clear to all that the burdens mandated through this process outweigh any benefits which may exist.

Mr. Chairman, this is the first day back from a vacation and I wish we had held this up for a few more days because this is not something I want to address this quickly after a pleasant 30 days away from here. I know it has to be done, but let's seriously consider what we are doing and consider the impact that this is going to have on the people who are going to end up paying these additional taxes.

Chairman RANGEL. If your district had the problems that my district had, you would recognize the vacation starts today for me. I am glad to be back here.

Does anyone seek recognition?

We have a panel before us led by Hon. Walter Tucker concerning a project that the committee is anxious to hear about in the sovereign State of California. We welcome all members of the delegation.

Ms. Allard is here. Mr. Horn is here. Ms. Waters is expected, and Congresswoman Harman is here. As others arrive, they will be recognized.

STATEMENT OF HON. WALTER R. TUCKER III, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. TUCKER. Thank you, Mr. Chairman and distinguished members of the committee.

Again thank you for hearing us today and recognizing this delegation that is concerned about alternative financing for a project called the Alameda Corridor. Before I give background on the Alameda Corridor, I would like to have entered into the record a formal statement which I will extrapolate from.

Chairman RANGEL. Without objection.

Mr. TUCKER. Thank you, Mr. Chairman.

I believe members of the committee do have a packet and comprised within the packet is also a map, which may be of use to them in following some of my commentary about the overall makeup of what is called the Alameda Corridor Project. This project was initiated by the Alameda Corridor Transportation Authority comprised of local communities stretching from downtown L.A. to the port of Los Angeles and the port of Long Beach, a 20-mile stretch.

Those two ports combined comprise the largest port facility in the country and the third largest in the world. They generate 100 million tons annually and they are obviously a very great source of exportation over the Pacific Rim which, as we heard during the campaign, is the most prodigious source of exports for this country.

This particular project came about as a result of a concern to consolidate and a concern to become more efficient. There are currently three separate railroads using four different routes to move cargo between downtown L.A. and the ports, resulting in inefficiencies and environmental problems.

The additional cost to shippers, who must put up with delays in transportation and transshipment of cargo destined for the East Coast and other points, is becoming difficult to justify. Even as we speak, there are reports about a possible construction of a port in Mexico in the Baja Peninsula, which would create some kind of competition for the ports of Los Angeles and Long Beach.

In light of a lot of impending discussions and negotiations on NAFTA, this may or may not bring such competition to fruition. We are trying to come up with alternative financing to better the facilities at the ports of Los Angeles and Long Beach; in other words, the Alameda Corridor. The issue is a question of how we can possibly come up with tax-exempt bond financing.

In IRS Code section 142(c), there is language as to the ability to have tax-exempt bond financing for ports and docks and wharves including airports. Our submission to this distinguished committee is that that particular code section be amended to include transportation and port-related facilities, such as the Alameda Corridor not exclusive to the Alameda Corridor, but certainly exemplary of the Alameda Corridor.

We believe that this is a natural extension, physical, legal and practical of the port and thereby not in any way thwarting or undermining the intent of the law, the intent of the code as written. For that reason, we believe that such an amendment should be made.

Mind you, even as the chairman indicated about the economic problems all over the country, we understand that in New York, in

New Jersey, and other parts of the country, port facilities are also undergoing expansion and progress, whether they are on our timetable or not. Such amendment we believe would be advantageous and beneficial to such projects throughout the whole country, not exclusive just to California. But as it relates to statistics as to California, we can share with you at this point that the projection is that 700,000 more jobs would be created in California by the year 2020.

Of course, some people have said as California goes, so goes the country. But the importance of this particular project is that it has national implications inasmuch as we are talking about the betterment and enhancement of trade on a national basis. Once again, the project will consolidate rail traffic and the total project would be estimated to cost $1.8 billion. We have looked at and you will see in our written statement, we have looked at the possibility of highway funds.

We have looked at the possibility of funds by the different ports; in fact, the ports have already put up hundreds of millions of dollars for the betterment of this project, $400 million contribution to be specific. Eight million dollars is expected from other local, State and Federal sources. There remains a $600 million shortfall and this is why we are coming to this committee to look at it these alternative sources.

The language of the proposed agreement to the Internal Revenue Code would permit the issuance of tax-exempt bonds by the Alameda Corridor Transportation Authority for the purpose of upgrading the 20-mile consolidated rail and highway corridor that we say is an extension of the physical port itself. Once again, this Alameda Corridor Transportation Authority, that we call ACTA, is a public entity and therefore a public entity will in fact own the corridor authority and in fact then come within the governmental guidelines, if you will, of the IRS 142(c) language.

The language of the amendment is entirely consistent with the public policy underlying the ability to issue tax-exempt bonds to finance ports because it covers only facilities that are integral to operations of the ports and dedicated to those operations.

I might also add that this project has received national support from the American Association of Port Authorities. This project has also received bipartisan support from Republicans and Democrats alike. I might cite a dear colleague letter that is included in the packet that has just about every signature of the members of the California delegation, crossing all party lines.

In summary, Mr. Chairman and members of the committee, we would ask that you look very closely at this. We understand that there have been numbers projected that this might cost $115 million over 5 years, but that our share would be measurably less than that.

I am sure that one of the first questions that you will raise is how will we pay for this. I am sure your committee is in the business of working out those kinds of details. But we are here today to get the ball rolling initially to say that this is a project of national and international import and hopefully export too, and that we believe that it is important to get this going now to look at alternative financial and financing sources and we believe the tax-exempt bond financing would be one of the best ways to do it.

Let me add, I am joined by another distinguished member of the California delegation, Ms. Waters. We want to welcome her as part of this delegation.

At this time, I would like to turn it over to Congresswoman Lucille Roybal-Allard.

[The prepared statement and attachments follow:]

Congress of the United States
House of Representatives
Washington, DC 20515

Written Testimony of

The Honorable Walter R. Tucker III
The Honorable Steve Horn
The Honorable Lucille Roybal-Allard
The Honorable Maxine Waters
The Honorable Jane Harman
The Honorable Xavier Becerra

Before the Subcommittee on Select Revenue Measures
Committee on Ways and Means
September 8, 1993

Good morning, Mr. Chairman, and Members of the Committee. We are here today in support of a proposed amendment to Section 142(c) of the Internal Revenue Code to allow exempt facility bonds to be issued for certain transportation facilities (including trackage and rail facilities) used for the transport of cargo or passengers mainly to or from airports, docks, or wharves, regardless of whether the facilities meet the governmental ownership requirement of Code section 142(b)(1).

While the proposed amendment could potentially affect projects around the Country, we would like to address its significance to a specific project with which we are very familiar -- the Alameda Transportation Corridor. This 20 mile corridor passes through our districts as it runs from downtown Los Angeles to the San Pedro Bay Ports, the largest port complex in the United States.

We have attached for the record a report that outlines the full scope of this project. However, we would like to tell you just enough about it to demonstrate why the amendment has national significance even if it were to apply to this project alone.

The Alameda Corridor Project

The Alameda Corridor Project was initiated by the Alameda Corridor Transportation Authority and an EIR funded by the Authority was certified January 14 of this year. The objective of the project is to consolidate rail traffic along the Alameda Street route that extends from the main rail yards in downtown Los Angeles to the two ports of Los Angeles and Long Beach. Currently, three separate railroads use four different routes to move their cargo between downtown and the ports. The inefficiencies and environmental problems associated with the current practice is unacceptable not only to the people who live and work in this area but to the competitive position of the United States in World markets. The additional cost to shippers who must put up with delays in the transhipment of cargo destined for the East Coast and other points is becoming increasingly difficult to justify and there are already reports that Mexico is hoping to attract foreign capital to the Baja Peninsula for the purpose of constructing a port to compete with the San Pedro Bay Ports.

Currently, cargo volumes through the port complex amount to roughly 100 million tons annually, and in a study completed by the U.S. Army Corps of Engineers on behalf of the two ports, these totals are projected to double by the year 2020. Indeed a new coal shipping agreement signed just recently opens the way to dramatically increase the flow of U.S. coal through the ports to Japan in the short term.

Mr. Chairman, we must make the surface transportation systems serving our ports competitive if we are to protect our foreign trade status in the World economy. At the same time we have to be mindful of the impact these systems have on the local communities and work to make them compatible with their surrounding communities. In the case of the consolidation of the three railroads on the Alameda corridor, 90 miles of tracks crossing 198 roads at grade level and having a direct impact on 71,000 people whose residences are within 500 feet of the rail line would be reduced to 20 miles of track, with zero grade crossings and directly affecting only 7,900 people whose residences are within 500 feet of the line. These are dramatic improvements that will significantly improve the efficiency of the ports and the quality of life for the people who live, work and travel the Alameda Corridor. As a demonstration of the broad support for the Alameda Corridor Project, we have attached a letter signed by 46 Members of the California Congressional Delegation supporting a request for federal funding.

Tax-Exempt Bond Eligibility

Under current law (section 142 of the Code) dock and wharf facilities are eligible for tax-exempt financing. Though the facilities generally must be included in the public port's jurisdiction, they are not limited solely to the actual dock or wharf facilities but include facilities which are functionally related and subordinate to the dock or wharf. Nevertheless, the Authority has been advised by legal counsel that rail facilities to transport cargo into and out of a port, even though dedicated to handling public port cargo, are not a dock or wharf or functionally related and subordinate to it. Therefore, a rail and highway corridor project such as the Alameda Corridor Project does not appear to be eligible for tax-exempt financing at this time.

Our legal counsel has further determined that the language of the proposed amendment to the Internal Revenue Code would permit the issuance of tax-exempt bonds by the Alameda Corridor Transportation Authority for the purpose of upgrading the 20 mile consolidated rail and highway corridor. We feel that the language of the amendment is entirely consistent with the public policy underlying the ability to issue tax-exempt bonds to finance ports because it covers only facilities that are integral to the operations of the ports and dedicated to those operations; under the amendment 80 percent of the utilization of the project must be directly connected to port activity. Consequently, we are asking that your Committee, Mr. Chairman, adopt the proposed amendment thereby setting in motion one of the most significant intermodal transportation projects in the Country.

Project Funding Plan

Mr. Chairman, the total cost of the Corridor consolidation and upgrading has been set at $1.8 billion. Already the San Pedro Bay Ports have committed $400 million toward the right-of-way acquisition and project construction. The Metropolitan Transportation Authority has just recently committed $8 million in local sales tax dollars for engineering. In addition to these local commitments, four of the grade crossings on the corridor were authorized for partial federal funding under the Intermodal Surface Transportation and Efficiency Act (ISTEA).

Local, state and federal highway funds will be used to fund $800 million in highway improvements and grade crossings along the corridor. While not all such funding can be identified in the current five year local funding cycle or ISTEA authorization, we are confident that subsequent extensions of ISTEA authorization will provide the federal funding that we feel is appropriate for this project. Indeed there is a very good chance that the highway segment of the Alameda Corridor Project will be included in the National Highway System when Congress completes its review in 1995. Once included we are relatively assured that the project can be completed by our target date of the year 2000.

Nevertheless, even with the Ports' $400 million contribution and the $800 million expected from other local, State and federal sources, there remains a $600 million shortfall. The State of California has given the Alameda Corridor Transportation Authority the ability to issue bonds for the purpose of improving the rail and highway corridor. The Authority is prepared to take such action, but Mr. Chairman, it desperately needs authority to issue tax-exempt bonds.

Consequently, we have come before this Committee to support an amendment that would give the Authority the ability to issue these bonds, which would be repaid from port and corridor user charges and fees.

Mr. Chairman, you have been most generous in taking our proposal under consideration, and in your deliberations on this tax bill we think you will find that the merits of our position are compelling. Indeed, we feel that this project can become a national model that demonstrates the willingness of all levels of government to work in concert toward a mutual goal with truly global economic significance.

Alameda Corridor Update

September 1993

On January 14, 1993, the Governing Board of the Alameda Corridor Transportation Authority (ACTA) certified the Final Environmental Impact Report and formally adopted the Alameda Corridor project. The action, which was unanimous, signifies a strong regional consensus that the Alameda Corridor should be built. Approximately 20 miles in length, the project is designed to facilitate rail and highway access to the ports of Los Angeles and Long Beach, while mitigating potentially adverse impacts of the ports' growth, including highway traffic congestion, air pollution, vehicle delays at grade crossings, and noise in residential areas.

Railroad Component

The goal of the railroad component of the Alameda Corridor is to consolidate the movements of the Union Pacific, Santa Fe, and Southern Pacific Railroads onto an improved right-of-way parallel to Alameda Street. South of Route 91 the railroad improvements will be at-grade with east-west grade separations. Between Route 91 and 25th Street the railway will be depressed, with the tracks in a trench, 33 feet deep and 47 feet wide. East-west streets will bridge straight across this trench.

Highway Component

South of Route 91:

The Ports Access Demonstration Project (PADP), the first phase of the Alameda Corridor, will widen Henry Ford Avenue and Alameda Street from four to six lanes between the Terminal Island Freeway and Route 91. The PADP also includes east-west grade separations at *Carson Street* and *Del Amo Boulevard*.

The PADP has been funded with federal grants in 1982, 1987, and 1991. The Intermodal Surface Transportation Efficiency Act (ISTEA) includes additional funds for grade separations at *Pacific Coast Highway*, *Sepulveda Boulevard*, *Anaheim Street*, and *Alameda Street* near Laurel Park Road. Funding for a freeway interchange at the intersection of the Terminal Island Freeway and Ocean Boulevard is also included in the legislation.

Alameda Corridor Update

North of Route 91:

Alameda Street, from the Artesia Freeway (SR 91) to the Santa Monica Freeway (I-10), will be reconstructed with the existing number of through lanes, thus maintaining little Alameda Street on the east side of the railroad tracks and main Alameda Street on the west side of the tracks. This would include alternative traffic engineering solutions, such as left turn pockets along main Alameda Street and new signalization at all existing crossings. No right-of-way would be taken along the east or west side of Alameda Street that would result in acquisition of buildings or create a non-conforming use.

Costs

The project will cost about $1.8 billion in inflated dollars.

Railroad Agreements

On August 18, 1993 the Port of Los Angeles terminated the agreement with Southern Pacific to purchase the property needed for the Alameda Corridor. The Port of Long Beach withdrew from the agreement on September 1, 1993. The ports have reaffirmed their support for the project, but have stated that more time is needed to resolve issues of title and clean-up of hazardous materials along the corridor. An operating agreement with all three railroad companies has also not been completed. All parties are working diligently to resolve the remaining issues.

Financing

To date, approximately $535 million has been committed for the project from federal, state, local and port sources. Remaining funds will come from future government grants, revenue bonds supported by the users of the corridor, and other sources. Depending on the availability of funds, the project may be constructed in phases. The goal, however, is to complete the project by the year 2000.

Alameda Corridor Update

Benefits of the Project

Increased Economic Activity

- The Alameda Corridor will allow the ports of Los Angeles and Long Beach to expand. Port growth is expected to generate 700,000 more jobs throughout Southern California by the year 2020.
- Because of improved access along the Corridor, redevelopment opportunities will be enhanced.
- The Alameda Corridor project itself will generate about 10,000 construction-related jobs in the central Los Angeles area.
- The corridor traverses several communities that were hit hard by the recent civil unrest. The project is an important element in the effort to rebuild Los Angeles.

Reduced Freeway Congestion/Improved Freeway Safety

- The Alameda Corridor will facilitate the development of near-dock and on-dock rail systems, reducing truck traffic on freeways and improving roadway safety.
- The Alameda Corridor will divert truck traffic to Alameda Street, which will further reduce truck traffic on the freeways.

Reduced Noise and Traffic Delays

- The project will result in an estimated 90 percent reduction in train-related noise in residential areas.
- The Alameda Corridor will lead to a 90 percent reduction in train-related traffic delays, eliminating some 14,000 vehicle hours of delay by the year 2020, due to the rerouting of trains and elimination of grade crossings.

Alameda Corridor Update

Improved Railroad Operations

- The project will result in an estimated 30 percent reduction in train operating hours, and a 75 percent reduction in the number of times trains have to stop for other trains to pass. (Stopped trains cause severe traffic tie-ups on streets)
- Train speeds will increase from 10-20 miles per hour to 30-40 miles per hour.

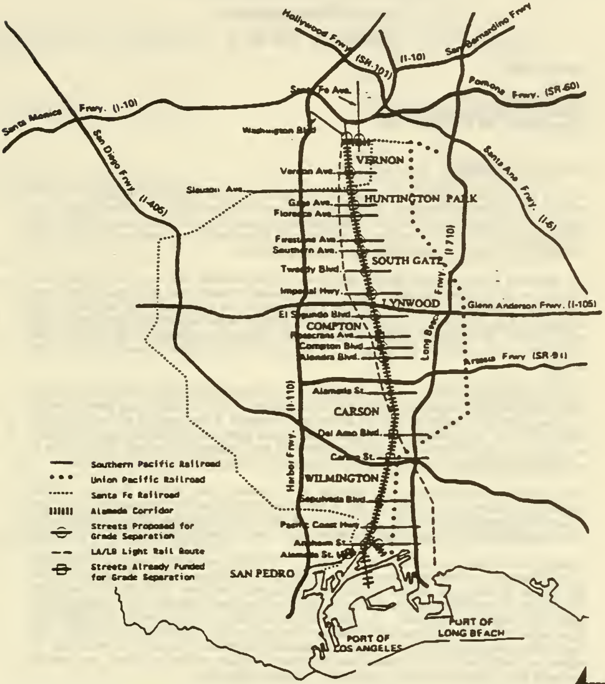
Improved Air Quality

- Smoother flowing freeways and a reduction in truck traffic will reduce vehicular emissions.
- The reduction in traffic delays at grade crossings will further reduce emissions.
- Railroad emissions (mostly NOx) will be reduced by 28%.
- The project increases the feasibility for electrification of the rail lines, which will also reduce emissions.

For additional information, please call or write

Gill Hicks, General Manager
Alameda Corridor Transportation Authority
6550 Miles Avenue, Room 113
Huntington Park, CA 90255
(213) 583-3080

The Alameda Corridor


Hollywood Frwy. (SR-101)
(I-10)
San Bernardino Frwy
Pomona Frwy. (SR-60)
Santa Monica Frwy. (I-10)
Santa Fe Ave.
Washington Blvd.
San Diego Frwy (I-405)
VERNON
Vernon Ave.
Slauson Ave.
Santa Ana Frwy. (I-5)
Gage Ave.
HUNTINGTON PARK
Florence Ave.
Firestone Ave.
Southern Ave.
SOUTH GATE
Tweedy Blvd.
(I-710)
Imperial Hwy.
Long Beach Frwy.
LYNWOOD
Glenn Anderson Frwy. (I-105)
El Segundo Blvd.
COMPTON
Rosecrans Ave.
Compton Blvd.
Alondra Blvd.
Artesia Frwy (SR-91)
Harbor Frwy. (I-110)
Alameda St.
CARSON
Del Amo Blvd.
Carson St.
WILMINGTON
Sepulveda Blvd.
Pacific Coast Hwy.
Anaheim St.
Alameda St.
SAN PEDRO
PORT OF LOS ANGELES
PORT OF LONG BEACH
Southern Pacific Railroad
Union Pacific Railroad
Santa Fe Railroad
Alameda Corridor
Streets Proposed for Grade Separation
LA/LB Light Rail Route
Streets Already Funded for Grade Separation

WALTER R. TUCKER, III
37TH DISTRICT, CALIFORNIA

COMMITTEES:
PUBLIC WORKS AND TRANSPORTATION
COMMITTEE ON SMALL BUSINESS

419 CANNON BUILDING
WASHINGTON, DC 205[illegible]
(202) 225-7924

DISTRICT OFFICES
145 E. COMPTON BLVD.
COMPTON, CA 90220
(310) [illegible]

Congreſs of the United States
House of Representatives
Washington, DC 20515

May 28, 1993

Honorable Bob Carr
Chairman, House Appropriations
Subcommittee on Transportation

Dear Mr. Chairman,

We are writing to request a $10 million appropriation from your subcommittee for FY 1994 for the Alameda Corridor. These funds, in combination with $16 million in local and state funding, would be committed to preliminary engineering, program management, and final design work for the Corridor. The Alameda Corridor Transportation Authority has completed work on the subcommittee's funding criteria.

The Alameda Corridor concept will be a new, state-of-the-art, and world-class truck and rail seaport access transportation line, stretching some 20 miles from the Los Angeles/Long Beach port complex to rail yards in East Los Angeles. As you know, the combined port complex of Los Angeles and Long Beach is the largest in the nation and the third largest in the world. Its Customs District is the largest customs contributor in the nation, with annual revenue exceeding $4 billion. An estimated 363,000 jobs depend on the Ports' activity.

As you know, both ports are now engaged in ambitious expansion activities in order to fulfill the identified capacity needs of the 21st Century. Yet, the Ports must have a means to move cargo efficiently in and out of the port complex if the benefits of the expansion activities are to be realized. Simply put, the largest port complex in the nation depends on the successful construction and operation of the Alameda Corridor if they are to continue to fulfill their role of economic engines for the region and for the nation.

The Alameda Corridor has the backing of Governor Pete Wilson, Senator Dianne Feinstein, Senator Barbara Boxer, The California Transportation Commission, the Ports of Los Angeles and Long Beach, the Southern California Association of Governments, the Los Angeles County Transportation Commission, and numerous local and state officials.

Federal investments in the Alameda Corridor will have substantial returns. Estimated annual customs revenue after completion of the port expansion projects is estimated to be $12 billion by the year 2020. While the Ports and the State of California are both committed to providing substantial funds for the Corridor, federal help is necessary to bring this project to fruition. We can think of few other projects which will fulfill the intermodal vision of the Intermodal Surface Transportation Efficiency Act of 1991. We hope your subcommittee can support the Alameda Corridor. Finally, we would like to extend an invitation to you to come and visit the Corridor personally so that you can see the need for, and potential of, this critical transportation line.

We thank you for your time and consideration of this request.

Walter Tucker III

Esteban E. Torres

Carlos J. Moorhead

Howard L. Berman

Vic Fazio

Calvin Dooley

Tony Beilenson

Lucille Roybal-Allard

Stephen Horn

Julian Dixon

Maxine Waters

Buck McKeon

Anna Eshoo

George E. Brown

Ronald V. Del

Lynn C. Wool

Nancy Pelosi

Henry A. Waxman

Howard Berman

John T. Doolittle

Pete Stark

Bob Filner

Dan Hamburg

Bill Thomas

Ed Royce

Ken Calvert

Al McCandless

Matthew G. Martinez

Dana Rohrabacher

Jane Harman

Jerry Lewis

Robert T. Matsui

Tom Lantos

David Dreier

Bob Dornan

Gary Condit

Chris Cox

Duncan Hunter

Elton Gallegly

George Miller

Richard Lehman

Jay Kim

Randy "Duke" Cunningham

Richard Pombo

Bill Baker

STATEMENT OF HON. LUCILLE ROYBAL-ALLARD, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Ms. ROYBAL-ALLARD. Thank you, Mr. Chairman, for the opportunity to appear before you today in support of granting tax-exempt bond status to the Alameda Corridor Project. This project will have significant economic benefits for both the country and the southern California region. I recently had the opportunity to fly over the project site with Secretary Peña. Viewing the project from that vantage point clearly illustrated how the project will link the two ports of Los Angeles and Long Beach, improve their transportation infrastructure and create the Nation's largest seaport complex.

National economic benefits will be delivered to the Congress that can be scored by the CBO. Accordingly, the national importance of this project must be underscored. The two ports currently handle about 100 million metric tons of goods annually for shipment throughout the Nation. The expansion in port capacity generated by the project will significantly improve both port access and cargo transportation.

This is not simply a regional project. It represents an effort to maintain our Nation's trade competitiveness in the face of increased competition from Mexico and other international ports. The project's surface transportation system improvements are needed to keep our ports competitive in the world economy.

The economic development benefits from this project on a local level are considerable as well. Cargo volume for the ports is projected to reach 210 million tons by the year 2020. This growth will generate 700,000 jobs throughout southern California and over 2 million nationally. The project will also generate approximately 10,000 construction jobs in the Los Angeles area and help to revitalize the local economy.

California has always served as a weather vane for the rest of the country. The entire Nation will benefit through the improved economy of California. The project will also have important environmental benefits by reducing traffic congestion and air pollution. Presently three railroad companies use four different tracks crossing at grade level, thereby directly impacting thousands of residents living within 500 feet of those lines.

The Alameda Corridor Project will reduce the number of tracks to a single major line with zero grade crossings and dramatically mitigate their impact upon local residents. The project will reduce train-related noise in residential areas by 90 percent and significantly reduce truck traffic on local freeways. The rail transportation system will be streamlined and made more cost-effective through a large reduction in train operating hours.

The Alameda Corridor Project will promote local, regional and national economic development in transportation planning. Tax-exempt bond status is critical to the continued construction of the project. We must not lose this opportunity to improve our transportation infrastructure and trade competitiveness.

Thank you.

Mr. TUCKER. Thank you, Mr. Chairman.

Any questions for Ms. Allard?

Chairman **RANGEL**. We would like to hear from the entire panel, and if there are questions, anyone can decide who would respond.

Mr. **TUCKER**. Thank you, Mr. Chairman.

At this time I will turn it over to Congresswoman Harman.

STATEMENT OF HON. JANE HARMAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Ms. **HARMAN**. Thank you, Mr. Chairman and thank you, Mr. Hancock, for permitting us all to testify on a bipartisan basis.

I am the designated lawyer on this committee who will address in a little more detail the tax-exempt financing questions. I hope if you have questions for me, you will refer them to my colleagues first.

Let me underscore several points which have already been made. First of all, the Alameda Corridor will be publicly owned by the Corridor Authority.

Second, 80 percent or more of the use of the corridor will be for the port. We want to make sure the committee understands this in connection with our request for tax-exempt financing. We have been advised by legal counsel that rail facilities to transport cargo into and out of a port, even though dedicated to handling public port cargo, are not a dock or wharf or functionally related and subordinate to it. It is for this reason that we are seeking the amendment, because we believe that what we have is not eligible for tax-exempt financing at this time. Should that opinion be different, we would be very happy, but we believe it cannot be different.

The language of the proposed amendment to the Internal Revenue Code would permit the issuance of tax-exempt bonds by the Alameda Corridor Transportation Authority, ACTA, a public authority for the purpose of upgrading the 20-mile consolidated rail and highway corridor.

Under the amendment, 80 percent of the utilization of the project must be directly connected to port activities. Let me point out that this is not a California amendment. This is a generic amendment and it could potentially affect projects around the country. It is supported by the American Association of Port Authorities for this reason and we understand that they will be submitting a statement in support for the record.

Points have already been made about the national significance of this. This is the largest port complex in the United States even as it stands today. There is no real alternative on the West Coast for entry and exit of goods and the real alternative on the West Coast, if we don't permit upgrading in some reasonable way in the short term, will be Mexico. Then we will be building Mexican jobs rather than American jobs, not just in California, but as these goods come in and out all across the United States and specifically benefiting many of our East Coast ports.

I am looking at you, Mr. Chairman, thinking about the ports of New York and New Jersey, which can logically be an entry and exit point for the same goods we are talking about entering and exiting this new expanded facility. Tax-exempt financing will permit revenue-raising of a piece of the $1.8 billion that we need for this expansion. It will build jobs across the United States and enable us effectively to compete with what we expect will be an expanded and very, very dangerous competitor to our south in Mexico in terms of denying U.S. jobs and building jobs in another country.

Thank you.

Let me add one thing. Mr. Hancock asked: "Do the benefits derived outweigh the burdens?" I want to answer that with a resounding yes.

Mr. TUCKER. Thank you.

Also let me add, Mr. Chairman, onto that aspect of her presentation, that $224 million in savings would occur with tax-exempt financing as opposed with taxable bonds over 30 years on this project.

I would like to turn it over now to Congressman Steve Horn.

STATEMENT OF HON. STEPHEN HORN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. HORN. Thank you very much.

As has been noted by several witnesses, this is a national project. It is generic for other future projects. I think the committee should know that right now the ports of Los Angeles and Long Beach generate $1 billion in terms of revenue in terms of customs and by the year 2020, which is the end of the overall port plan for both ports, there will be roughly $5 billion in revenue coming into the Federal Treasury.

This is the major access point for trade from and to Asia, and this is also going to do a lot to improve the lives of thousands of citizens along these train tracks. It brings together three railroads in one corridor that go transcontinental and cover every one of the States now represented on this committee so that they can go right up to take the containers off the ships and eliminate most of the truck traffic except for regional southern California.

In terms of the total financing of the project, the total cost is estimated at $1.8 billion. The two ports, the port of Long Beach and the port of Los Angeles, the so-called San Pedro Bay ports, have committed $400 million toward right-of-way acquisition and project construction. The Metropolitan Transportation Authority of the region, Los Angeles County primarily, has committed $8 million in local sales tax dollars for engineering. Four of the 35 grade crossings on the corridor have already been authorized in the Intermodal Surface Transportation and Efficiency Act, which the Congress approved last year. The local, State and Federal highway funds will be used to fund $800 million in highway improvements and grade crossings along the corridor, and that will improve the lives of roughly 60,000 to 70,000 citizens where the traffic disrupts their lives.

Although not all the funding has been identified yet in the highway sector because some might be in future bills passed by the Congress, there is a very good chance that the highway segment will be included in the national highway system when Congress completes that review in 1995.

Even with the $400 million contribution of the ports, the $800 million and more expected from local, State and Federal sources, there remains that $600 million shortfall. That is why the delegation—and you have in the official filing of our testimony a letter I believe signed by 48 of the 52 members of the delegation—is asking for this generic authority with which we could issue tax-exempt bonds which would be retired based on the fees collected by the board from the rail and the truck traffic that will be going in and out of the port.

So we hope that you will grant that to the authority, the ability to issue tax-exempt bonds that would be repaid over the next several decades.

I would now like to ask my colleague Maxine Waters to wrap up the discussion.

STATEMENT OF HON. MAXINE WATERS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Ms. WATERS. Thank you very much.

I am extremely pleased to join my southern California colleagues at this hearing to speak on behalf of the Alameda Corridor Project. The Alameda Corridor Project, if fully funded and constructed, promises to be an efficient, productive, and resourceful addition to the entire southern California economy.

While the benefits of this program would be regional indeed, national in scope, they would be a direct link to my own congressional district, the 35th Congressional District. The project would run through my congressional district at two points, following Alameda Street between Jefferson Boulevard and Slawson Boulevard and again on Alameda between 79th and 91st Streets.

In these areas the Alameda Corridor would substantially improve the living conditions of many of my constituents, who currently live within 500 feet of the 3 operating rail lines. This would be true all along the corridor and would affect literally thousands of southern California residents.

In my brief presentation, I would like to focus on the economic impact of the project in southern California. By way of background, it is important to talk about the state of the southern California economy overall. The State of California is mired in a 3-year recession which has already cost 800,000 jobs. Military downsizing and other global economic factors have taken a disproportionate toll in California and in our region in particular. The overall unemployment in the State still is over 10 percent and worse along the corridor, leaving 1.4 million people out of work. In many parts of southern California that would be touched by the Alameda Corridor, unemployment rates are indeed much, much higher.

Since 1989, Los Angeles County has lost 40,000 high-tech manufacturing jobs due to military downsizing. This translates into $1.5 billion in lost wages in the county.

It is against this backdrop that we approach the huge economic and competitive potential of the Alameda Corridor Project. First, construction of the Alameda Corridor alone will generate an estimated 10,000 jobs in the central Los Angeles area. The improved efficiency of the new corridor will dramatically expand import opportunities by the entire region, a region that is threatened by tough economic competition from Mexico. This could lead to hundreds of thousands of new jobs, up to 700,000 by the year 2020, according to some estimates.

The benefits from the increased use of the Long Beach and Los Angeles ports would lead to expanded development opportunities as well.

Finally, the area is trying desperately to rebuild. We stand to gain enormously from the Alameda Corridor Project, as it would cut through some of the most economically deprived sections of L.A. County.

In conclusion, Mr. Chairman and members, the proposed Alameda Corridor Project can work. All we need is a simple change in the tax law to get the program off the ground. I hope you and this committee will help us realize the enormous economic potential of this very worthwhile program.

Thank you very much, Mr. Chairman.

Mr. TUCKER. I believe that concludes our presentation, Mr. Chairman.

Chairman RANGEL. Thank you.

Where is this project? Is this a State-operated project? Will the State be in charge? This is a subdivision of the State government that is going to operate the——

Mr. TUCKER. It is operated by the Alameda Corridor Transportation Authority, which is a body that has been given jurisdiction on a local basis, but it derives from the State, yes.

Chairman RANGEL. So they are private sector people who are on the board?

Mr. TUCKER. The corridor is comprised of the local communities; if you look at the map, communities like Compton and Lynwood.

Chairman RANGEL. Who would issue the bonds?

Mr. TUCKER. I believe that the corridor, the Transportation Authority would do it.

Chairman RANGEL. How much has been invested in this project approximately?

Mr. TUCKER. How much has been invested already?

Chairman RANGEL. Already.

Mr. TUCKER. Let me find out how many hundreds of millions have been invested. Over $100 million has been invested already in demonstration projects such as overpasses and underpasses.

Chairman RANGEL. Was the investment made with the hope that tax-exempt bonds would be made available?

Mr. TUCKER. The investment was made at the time with highway funds and they anticipated, I believe, that they would have enough to complete the project, but I think that they did anticipate at the same time that tax-exempt bonds would have to come in to assist at some point in time.

Chairman RANGEL. But they are private investment funds in the project? It is all not publicly funded, is it?

Mr. TUCKER. Yes, there are private investment funds in the project by way of the railroad, Southern Pacific and others.

Chairman RANGEL. Why did they choose to make this generic and not a specific exemption for this particular project?

Mr. TUCKER. I believe, Mr. Chairman, that even though we could maybe lay claim to the fact that we have special interests here, that we believe that in the long run or in the aggregate picture, as we indicated earlier, there may be other port facilities that might benefit from that language generically. I can defer as to that.

Ms. HARMAN. I wanted to add that we understand that other ports are learning from this whole concept of a transportation corridor and we would think it unwise for the committee to limit this possibility just to this very important West Coast port. If, for example, the ports of New York and New Jersey wanted to build a similar transportation corridor and have part of the financing come from tax-exempt bonds, we would think it logical given the need in California for a similar facility to be able to be put together on the East Coast.

Chairman RANGEL. The budget people have an illogical way in which they score this. This would be considered a revenue loss even though no revenue would be generated if the bonds didn't issue; so therefore it would be more difficult to determine how much this would cost if it is generic.

Mr. HORN. Could I comment that this is a natural extension of the docks and wharves provision, as I am sure you know, and we wouldn't be opposed to a particular designation for it, but I think it makes sense that some of the major ports in the United States might wish to access such authority to do a similar thing, combine transportation corridors so you would get more rapid service, much more efficient lower cost domestically across all your States than the now system of both ship, truck to connector rail lines.

Chairman RANGEL. Since this is a national, or indeed has international implications, how far up in the administration do you have support for this?

Mr. TUCKER. Well, we have support for this, Mr. Chairman, from the Secretary of Transportation. We have support from the Secretary of Commerce. I have spoken with the President about it. So we have an extreme amount of support for it.

Mr. HORN. I might add on that point that when Secretary Peña visited there, he said the corridor is not only a California issue, it is a national priority.

Chairman RANGEL. I would think that is a bit more than persuasive.

Does any member seek recognition?

Mr. Camp.

Mr. CAMP. Thank you, Mr. Chairman.

Ms. Harman, this doesn't change the bond volume cap, does it?

Ms. HARMAN. It doesn't change the cap. My understanding is that as defined this way, this would not be part of that cap. This would just be an extension to an existing exemption for docks and wharves and it would make it apply to this logical transportation, 20-mile transportation corridor that comes directly off the dock.

Mr. CAMP. Has Joint Tax issued a revenue estimate on this project?

Ms. HARMAN. That is the one we have been talking about, the $115 million figure. As we have been discussing with the chairman, it is for all the projects, not just the Alameda Corridor Project. We believe our portion of that is $35 million.

As the chairman discussed, he wants to know what the rest of it is. We have felt that making this a generic amendment would be more logical in public policy terms. As Mr. Horn said, we would not resist the committee deciding it should just apply to this project, but we think it makes more sense to apply it generically.

Mr. CAMP. Was there a policy reason behind saying that a railroad that goes to a port is not functionally related to the port? Was it because private interests were involved in the railroad? I am confused as to why the ruling came down the way it did, making this legislation necessary.

Ms. HARMAN. I would assume we could make the ruling available to the committee. There is no specific—this is the IRS position, and I think it is derived from a kind of common sense concept of what a port is, that 20-mile extension of some kind of a transportation corridor is not a port. We think it is in terms of conceptually understanding what is the purpose of the port as an entry and exit point for goods.

Obviously, the consolidation of the rail and other systems into this port will make this an efficient port and able to compete with Mexico. Similarly other important U.S. ports could do the same thing, those that are impacted by traffic and noise, et cetera.

We feel therefore that the United States would be in a much better position in terms of international trade, and this is in everyone's interest, for a very, very modest cost.

Mr. CAMP. Thank you.

Your comments have been very helpful and I look forward to working with you on this.

Chairman RANGEL. Mr. Payne.

Mr. PAYNE. I think that what you are proposing has important and positive public policy implications. I was on the Public Works Committee last year as we wrote the Intermodal Surface Transportation and Efficiency Act. You are proposing putting into practice what we were attempting to look at in that bill in terms of a blueprint for the Nation of intermodality and how various modes of transportation could best work together in order to produce the most efficient system and one that would help us compete with other nations around the world.

So I think this is a very important proposal that you are making and one that deserves very serious consideration.

Thank you.

Chairman RANGEL. Mr. Kopetski.

Mr. KOPETSKI. I think this is creative financing. My question has to do with profits and whether the railroads are saying that this is the only way that they can make this go is for Government to subsidize this corridor, that they wouldn't make money off of it unless Government stepped in and financed this capital project.

Mr. HORN. Could I comment? This is not about profits for railroads. I grew up in the Hiram Johnson tradition of being against big railroads in California. This is about congestion in the southland of L.A. County and Orange County and clogging up the freeways and not being able to readily deliver products given the unbelievable expansion that is going to take place in the next three decades at these port facilities.

The idea is to—that won't decrease traffic very much. We would like it to stay where it is because trucks will still need the regional southern California delivery. But if you are going to move produce through that port by containers or into the Midwest, into the Northwest, into the South, even into Mexico, then we need to get moving from the dock side. It goes straight from the ship into the train and away by train. It solves a lot of pollution and a lot of people problems and would be a more efficient operation simply on congestion.

Mr. KOPETSKI. So the railroads are not going to make any money on this?

Mr. HORN. We are trying to buy out the railroads. The ports are doing this. The two ports have agreed to do that. There are now three separate lines going into the port, Santa Fe, Union Pacific, and Southern Pacific. The best corridor for getting the traffic into where it is assembled to move east and north and south is to take this Alameda Corridor, 22 miles long, which is owned by Southern Pacific Railroad. The ports are going to buy them out, and it is just a matter of agreeing on the price, and the railroads will pay a fee to use this corridor. It is not a freebie for them. It brings them dockside in the port of Los Angeles, the port of Long Beach, and all three will be using this one corridor.

Mr. KOPETSKI. Thank you, Mr. Chairman.

Chairman RANGEL. It certainly sounds like an exciting project and it would have impact on our trade policy. I would think the administration might even be able to identify similar projects that could work in an overall national trade policy, and as all of you know, if this came as a part of an administration package to us, they would be able to find it much easier to pay for it since we have to hurt people, industries, and other projects in order to bring about this balance.

In any event, I would encourage you to work with the administration and to get as much support as they can give it since this committee tries not only to write good tax policy, but also to try to avoid conflict with the administration as well when that is possible. So it sounds like a national project with international implications, and I think it should be raised to that level since it has definitely regional support.

I thank you for the time that you have spent with us today.

Mr. TUCKER. Thank you very much, Mr. Chairman. We look forward to giving you and your subcommittee more information and even letters of support from the administration on the project. Thank you, again.

Chairman RANGEL. Thank you.

[The information follows:]

STEPHEN HORN
38th District, California

Washington Office:
1023 Longworth House Office Building
Washington, DC 20516
(202) 225-6676

District Office:
4010 Watson Plaza Drive
Suite 160
Lakewood, CA 90712
(310) 425-1336

Congress of the United States
House of Representatives
Washington, DC 20515

Committee:
PUBLIC WORKS AND TRANSPORTATION
Subcommittees
Aviation
Water Resources and Environment

Committee:
GOVERNMENT OPERATIONS
Subcommittees
Government Information, Justice, Transportation and Agriculture
Human Resources and Intergovernmental Relations

September 28, 1993

The Honorable Charles B. Rangel
Chairman
Select Revenue Measures Subcommittee
Committee On Ways and Means
1105 Longworth
Washington, D.C., 20515

Dear Mr. Chairman:

Thank you for the opportunity to testify before your subcommittee Wednesday, September 8.

I hope we were able to effectively communicate the importance of the Alameda Corridor not only to the Southern California region, but also to the nation. The critical bottleneck to the growth of the Long Beach - Los Angeles port complex is land-side access. If cargo cannot move efficiently in and out of the ports through the tremendous congestion of the Los Angeles region, then all expansion activities will be for naught. The answer to this problem is the Alameda Corridor.

In response to your question regarding Administration support for the Corridor, I have attached an article from the September 2, 1993 Journal of Commerce entitled, "Pena Pledges Federal Help For Alameda Corridor." I would also like to correct a figure I gave with regard to the amount of Customs revenue the combined Ports generate. I was mistaken when I stated at the hearing that the current annual revenue is approximately $1 billion. In fact, current combined Customs revenue is more than $3 billion per year. With the 2020 expansion plans, Customs receipts are expected to grow to $8 billion per year. Clearly, the federal stake in this investment is more than substantial. Tax-exempt bond authority would seem a small down payment in view of the returns.

Again, thank you for the opportunity to appear before your subcommittee. If I may answer any further questions you have on the Alameda Corridor, please do not hesitate to call.

With kindest regards,

Sincerely yours,

STEPHEN HORN
Member of Congress

SH:rmt

THE JOURNAL OF COMMERCE -- THURSDAY, SEPTEMBER 2, 1993

Pena Pledges Federal Help For Alameda Corridor

By KEVIN G. HALL
Journal of Commerce Staff

LOS ANGELES — Touring Southern California ports, Transportation Secretary Federico Pena has pledged the federal government will play a greater role in the development of the nation's largest intermodal infrastructure project.

Mr. Pena toured the ports of Los Angeles and Long Beach this week to get a better understanding of how intermodal innovations have made the twin waterfront facilities the nation's largest containerport complex.

PENA

The secretary also flew over the proposed Alameda Corridor, a planned $1.8 million consolidated truck and rail corridor from the ports to railyards in the east part of sprawling Los Angeles.

The corridor is being planned in an effort to relieve expected massive congestion associated with the predicted doubling of cargo moving through the bustling ports by the year 2020.

Project backers like Geraldine Knatz, planning director of the Port of Long Beach, used the helicopter flight and visit with the secretary to sell the benefits the project will yield to the federal government.

Among the benefits, she said, is that the project will allow for increased freight movements worth billions annually to the U.S. Customs Service.

"They're (Customs receipts) going to grow by another $5.2 billion," said Ms. Knatz, noting receipts are expected to grow from $3 billion annually to $8 billion.

The growth in Customs receipts will eclipse the $1.2 billion funding shortfall that now exists for the project, a shortfall that represents only 23% of the expected receipts.

Although the plan was dealt a major setback last month when the Port of Los Angeles backed out of its share of a $260 million purchase of trackage needed for the project, the idea remains viable and the secretary said he came to get a firsthand look at the project.

Two of Mr. Pena's predecessors were also familiar with the massive intermodal project but did little to rally federal funding, which to date remains at roughly $48 million of the $543 million in secured commitments.

Saying he hoped to "to be the last" transportation secretary to deal with the intermodal project, Mr. Pena said once the ports have concluded their track-purchase agreement with Southern Pacific Lines, the federal government will step up its role.

"We'll have a definitive statement about the need from the federal government in terms of our contribution," the secretary said during an interview on the docks of American President Lines' terminal in Los Angeles. "Once we have that then we go to work and begin to decide where we can get those dollars to make the Alameda Corridor a reality."

Added Richard Mintz, Mr. Pena's spokesman, "I think you're going to see additional federal commitments down the road."

Separately, Mr. Pena handed over a $49.6 million check to expand the city's Metro Red Line subway, saying the project will help rebuild California's struggling economy.

The money will be used to continue construction of the Wilshire Corridor segment, which follows Wilshire Boulevard from the Westlake area to Hollywood.

The $1.6 billion subway, already in operation downtown, is scheduled for completion in 1996.

"This is the largest federal investment in any transit agency in this nation," Mr. Pena said.

Chairman RANGEL. The next panel consists of the Association of Christian Schools International, John Holmes, director of government affairs; the PHH Corp. in Maryland, Samuel Wright, vice president and general counsel; the Independent Bakers Association, Dale Cox, from San Raphael, Calif., accompanied by the chairman of the Independents Contractors Committee, Robert Fanelli; Fred Lazarus, vice president of the Association of Independent Colleges of Art and Design, from Florida; and the University of Florida Health Science Center, Stanley Rosenkranz, general counsel.

Because of the severe limitations on time that we have and the large number of witnesses, the Chair would ask that the witnesses restrict their oral testimony to 5 minutes with the understanding, if there is no objection from the committee, that your full written statements will be entered into the record.

The Chair, hearing no objections, will proceed with Dr. Holmes.

STATEMENT OF JOHN C. HOLMES, ED.D., DIRECTOR, GOVERNMENT AFFAIRS, ASSOCIATION OF CHRISTIAN SCHOOLS INTERNATIONAL

Mr. HOLMES. Good morning, Mr. Chairman, and members of the committee. Thank you for this opportunity to speak concerning revenue issue No. 8, which would restore fair treatment of lay-board religious schools under the Federal Unemployment Tax Act.

With me today is Dr. Pauline Washington, who is an administrator and founder of the Washington-McLaughlin Christian School in Takoma Park, Md. She is right over the Washington line. She is right behind me. Also with me is Rabbi Abba Cohen, who is with Agudath Israel of America, and also Curran Tiffany, attorney with the National Association of Evangelicals.

ACSI serves over 3,000 schools. ACSI schools follow a policy of racial nondiscrimination, reaffirming this policy annually. I come to address the problem of unfair treatment and inequity within the Tax Code concerning about 15 percent of our Christian schools, and all of the Jewish day schools represented by Agudath Israel of America. About 20 percent of all religious schools in America are not owned or affiliated directly with the church. The schools we seek to exempt from mandatory participation in the Federal Unemployment Tax Act are as religious as church or synagogue-affiliated schools.

They are denied equal treatment without anyone even suggesting that they are not religious, but they are under the governance of boards of religious laymen rather than clergy. Dr. Washington, with me today, is an administrator of such a school. Because of this distinction without difference, this small portion of religious schools in America has been forced to participate in FUTA. The 50 States could mandate participation in State unemployment laws, but the majority of the States, 46, I believe, choose to mirror the Federal statute which exempts church-related schools.

Issue 8, which is identical to Congressman Crane's H.R. 828, would offer the same choice of participation in FUTA to lay-board religious schools and alleviate the inequity faced by these schools because of the technicality of control. For religious schools, their faith is far more important than their organizational structure whether or not they are affiliated with another religious body.

Allow me to give a personal example of the double standard now faced by religious schools not owned or affiliated with a church or synagogue. I served as a superintendent of four Christian schools in Southern California in the same area that they were talking about this morning. The schools were operated by a church in Los Angeles County. The school board discussed how the secondary schools could serve a wider constituency of evangelical Christian community if the junior highs and the high schools were not viewed by the parents as a ministry of a particular church because of doctrinal distinctions. A change of status seemed logical to the board members and the sponsoring church officials shared this concern and approved the legal separation of the two secondary schools.

A board of laymen was formed and began to function as an independent religious educational institution. The teachers were the same, the chapel services were the same, the curriculum was the same, the Bible classes were the same, everything except the relationship with the church remained the same, but the schools, considered too religious to be eligible for participation in various Federal and State funding sources, were no longer exempt from mandatory participation in FUTA. This was a triumph of form over substance. Issue 8 asks no more or less than what church schools now have by virtue of section 3309(b)(1) of the Internal Revenue Code of 1986, which relates to exemption. When the exemption section was enacted, Congress exempted employees who worked in churches and religious organizations operated by churches. Then in 1981 in *St. Martin Evangelical Lutheran Church* v. *the State of South Dakota*, the U.S. Supreme Court ruled that the exemption extended to elementary and secondary schools that churches operate.

Any religious school that receives exemption as a result of this measure has established the fact with the Internal Revenue Service that it operates primarily for religious purposes described in section 501(c)(3) and is exempt from tax under the 501(a).

We believe that Congress inadvertently failed to exempt lay-board controlled religious schools from FUTA because these schools are not numerous and Congress was simply unaware of the difference and the technicalities of affiliation from other religious schools.

Back in 1988 an identical amendment to Issue No. 8 was sponsored by Senator Strom Thurmond and it was unanimously adopted by the Senate during consideration of the tax technical corrections bill. Unfortunately, the amendment was dropped in conference. This amendment was viewed by the Joint Committee on Taxation as revenue neutral. The committee said that the net budget effect of this bill would actually gain the Federal Government less than $5 million in the fiscal year and negligible effect each year thereafter. Therefore they viewed it as revenue neutral. Thus there is no fiscal burden to the Government to provide tax equity and simple justice.

We urge this subcommittee to carefully consider this remedial measure. Its passage would help lay-board religious schools, Catholic, Jewish, and Protestant, which are helping American children succeed morally, spiritually, and academically. Thank you for listening to our concerns.

Chairman RANGEL. Thank you.

[The prepared statement follows:]

Testimony of

Dr. John C. Holmes, Director for Government Affairs
Association of Christian Schools International

Concerning

MISCELLANEOUS REVENUE ISSUE #8

Before

Subcommittee on Select Revenue Measures,
Committee on Ways and Means,
U. S. House of Representatives
The Honorable Charles B. Rangel, Chairman
September 8, 1993

Mr. Chairman and Members of the Subcommittee on Select Revenue Measures:

Thank you for this opportunity to address you today concerning Miscellaneous Revenue Issue #8, which would restore fair treatment of lay-board religious schools which come under the Federal Unemployment Tax Act. My name is Dr. John Holmes and I serve here in Washington, DC as the Association of Christian Schools International's Director for Government Affairs. With me today is Dr. Pauline Washington who is the administrator and founder of the Washington-McLaughlin Christian School in Takoma Park, Maryland.

The Association of Christian Schools International is the largest association of evangelical Christian schools in the nation with over three thousand schools and colleges. We now serve nearly 570,000 students. All ACSI schools follow a policy of racial non-discrimination, re-affirming this policy on an annual basis when they renew their membership. I come here today to address a problem of unfair treatment and inequity within the tax code concerning about three out of every twenty of our member Christian schools and nearly all of the Jewish Day Schools that are represented by Agudath Israel of America.

Approximately one out of every five religious schools in America is not owned or affiliated with a particular church or synagogue. The elementary and secondary schools we seek to exempt from mandatory participation in the Federal Unemployment Tax Act are as pervasively religious as a church or synagogue owned or affiliated schools would be. They are denied equal treatment, without anyone even suggesting that they are not religious, because they lack formal church affiliation and are governed by boards of religious laymen. Dr. Washington is the administrator of such a school.

Because of this distinction, without difference, this small portion of religious schools in America has been forced to participate in FUTA. On their own, the fifty states could make participation in state unemployment laws mandatory. However, an overwhelming majority of states choose to mirror the federal statute, which exempts church related or affiliated elementary and secondary religious schools. Miscellaneous Revenue Issue #8, which I understand is identical to Congressman Phil Crane's H. R. 828, would offer the same choice of participation in FUTA to lay-board religious schools and alleviate the inequity faced by these schools because of the technicality of control. For religious schools, their faith is far more important than their organizational structure, whether or not they are affiliated with another religious body.

Allow me to give a personal example of the double standard now faced by religious schools which are not owned or affiliated with a church or synagogue. Before coming to Washington, DC, I served as a superintendent of four evangelical Christian schools in southern California. All of the schools were operated under the umbrella of a church in Los Angeles County. Much discussion by the evangelical school board revolved around how our secondary schools could more adequately serve a wider constituency of the evangelical Christian community if the junior and senior high schools were not viewed by parents as a ministry of a particular church, because of doctrinal distinctives. Since the secondary schools sought to meet the needs of the greater evangelical community and not stress particular doctrinal distinctives, a change of status seemed logical to a majority of the board members and church officers.

The sponsoring church officials shared this concern and approved the legal separation of the secondary schools. A board of laymen was formed and began to function as an independent religious educational institution. The teachers were the same, the chapel services were the same, the curriculum was the same, the Bible classes were the same--everything except the relationship with the church remained the same. But the schools, which were considered too religious to be eligible for participation in various federal and state funding sources, were no longer exempt from mandatory participation in federal unemployment tax. This is a triumph of form over substance.

Each of the states has slightly different ways of handling unemployment tax, but approximately 46 states largely mirror the federal code. The wording proposed in Miscellaneous Revenue Issue #8 asks no more or less than what private religious schools that are operated or affiliated with a church or synagogue now have by virtue of Section 3309 (b)(1) of the Internal Revenue Code of 1986, which relates to exemption. Back when the exemption section was enacted, Congress exempted employees who worked for churches and religious organizations operated by churches. Subsequently, in 1981 in St. Martin Evangelical Lutheran Church v. South Dakota, the U. S. Supreme Court ruled that the exemption extended to elementary and secondary schools that churches operate.

Any religious elementary or secondary school that would receive exemption as a result of this measure would have already established the fact with the Internal Revenue Service that it "operated primarily for religious purposes, which is described in section 501(c)(3), and which is exempt from tax under section 501(a)."

Lay-board religious schools provide excellent education and moral training for American young people with a caring environment where students can achieve academically. My own doctoral research in Los Angeles on why black, Hispanic and white parents chose to send their children to evangelical Christian schools attests to this fact. Parents of all ethnic backgrounds chose to re-enroll their children because of the caring environment that they found in evangelical Christian schools.

We believe that Congress failed to exempt lay-board controlled religious schools from FUTA because these schools are not numerous, and Congress was simply unaware of the difference in the technicalities of affiliation from other religious schools. This oversight was not intentional discrimination on Congress' part, merely inadvertent. Back in 1988, an identical amendment to Miscellaneous Revenue Issue #8 was sponsored by Senator Strom Thurmond. The amendment was unanimously adopted by the Senate during consideration of the tax technical corrections bill. Unfortunately, the amendment was dropped in conference. We do not know why. Amendment No. 3443 (in the 100th Congress) was viewed by the Joint Committee on Taxation as revenue neutral. The Joint Committee on Taxation said the "net budget effect of this bill would be a gain of less than $5 million in the fiscal year. . .and a negligible effect each year thereafter." *(Congressional Record, 100th Congress, S14861-2)* Thus, there is no fiscal burden to the government to provide tax equity and simple justice.

Groups that are supportive of Miscellaneous Revenue Issue #8 include Agudath Israel of America, the American Association of Christian Schools, Coalitions for America, Concerned Women for America, the Marian [Catholic] Secondary Schools Association and the National Association of Evangelicals. We urge this Subcommittee to carefully consider this remedial measure. Its passage would help lay-board religious schools which are helping American children succeed morally, spiritually and academically.

Again, thank you for listening to our concerns.

Chairman Rangel. Mr. Wright.

STATEMENT OF SAMUEL H. WRIGHT, VICE PRESIDENT AND GENERAL COUNSEL; PHH CORP., HUNT VALLEY, MD.

Mr. Wright. Thank you, Mr. Chairman. I am vice president and general counsel of PHH Corp. I am testifying on behalf of PHH and the American Automotive Leasing Association, of which PHH is a member. Our company leases and provides management services for approximately 400,000 vehicles throughout North America.

AALA members lease and manage the majority of sales and service vehicles used by businesses throughout our country, a market that exceeds 3½ million vehicles. We strongly support the proposal to modify the computation of depreciation under the alternative minimum tax by increasing the acceleration method from 150 percent of declining balance to 200 percent. This proposal would go a long way toward redressing unfair treatment accorded to these assets under our tax system.

Passenger cars and trucks are allowed inadequate depreciation deductions under both alternative and regular income tax. These assets receive worse depreciation treatment than other business assets. This discrimination artificially increases the actual cost of these business assets, distorting business investment decisions, reducing the number of passenger vehicles purchased. Prior to 1986 automobiles were depreciated over 3 years using a 200 percent declining balance method. This provided a modest amount of incentive depreciation, consistent with the regular tax depreciation.

Unfortunately, in 1986 Congress lengthened the writeoff period to 5 years. This change removed all tax incentive for passenger cars and light trucks from regular tax depreciation. The 1986 legislation also included a corporate alternative minimum tax. Under the AMT, depreciation deductions were intended to approximate economic depreciation in the value of business assets. For business-use passenger vehicles, this period was set at the same 5-year period provided under the regular tax, but using a 150 percent declining balance method.

In 1989 Congress directed the Treasury Department to conduct a study of the proper class life of cars and light trucks. In 1981 the Treasury Department issued a report, which recommended a class life of 3.5 years for business-use cars generally. They also concluded that the actual useful life of cars in business fleets, the type of vehicles I am talking about today, is 2.8 years. The 1991 report is just the latest in a long line of Treasury determinations going back over 50 years, concluding that cars should be depreciated over a 3-year period. Shortening the regular tax recovery period for passenger vehicles to 3 years to reflect the Treasury Department's report would simply reinstate an incentive comparable to that accorded other business assets.

As I mentioned earlier, the Treasury Department's 1991 study concludes that the appropriate class life for business-use cars should be 3.5 years, 2.8 years for fleet cars. Thus, in order to reflect real world depreciation, the cost recovery period under AMT for cars should be no more than 3.5 years. The economic effect of the proposal to increase the acceleration method for business-use passenger vehicles from 150 to 200 percent is equivalent to shortening the AMT recovery period from 5 to 4 years. Increasing the acceleration method from 150 to 200 percent would therefore merely allow us to deduct amounts which reflect the actual decline in the value of our business assets, nothing more.

I should mention that the recent repeal of the ACE adjustment for depreciation under AMT was a substantial simplification. However, repealing ACE did not provide business-use vehicles with economic depreciation and did not remove the discrimination against these assets as compared with other business assets.

In closing, I would like to emphasize the importance of this change to the entire economy. More than 95 percent of business-use cars are products of domestic manufacturers. Over 125,000 businesses have fleets of 10 or more automobiles. Business-use cars also account for over one-third of all automobiles sold by domestic manufacturers, over 3.5 million cars annually. Merely providing these vehicles with depreciation rules, which reflect economic reality, will increase sales and result in more economic growth and more jobs not only in the automobile manufacturing industry, but also in industries such as steel, glass, rubber, textiles, and semiconductors that supply the automobile manufacturers. Thank you, Mr. Chairman, and the committee for your attention.

Chairman RANGEL. Thank you, Mr. Wright.

[The prepared statement follows:]

Statement of
Samuel H. Wright
American Automotive Leasing Association

Before
The Subcommittee on Select Revenue Measures
Committee on Ways and Means
United States House of Representatives

September 8, 1993

Mr. Chairman:

My name is Samuel H. Wright. I am the vice president and general counsel of PHH Corporation which is located in Hunt Valley, Maryland. I am testifying on behalf of PHH Corporation and the American Automotive Leasing Association of which PHH is a member.

PHH Corporation is a $4 billion company whose stock is traded on the New York Stock Exchange. Through its subsidiary, PHH FleetAmerica, PHH Corporation leases and provides management services for approximately 400,000 vehicles throughout North America. AALA is composed of companies who lease and manage the majority of sales and service vehicles used by businesses throughout our country, a market exceeding three and a half million vehicles.

We want to thank you for giving us the opportunity to present our views of the proposal to modify the computation of depreciation under the alternative minimum tax by increasing the acceleration method from the 150 percent declining balance method applicable under present law to a 200 percent declining balance method. This proposal would go a long way toward redressing unfair treatment accorded to these assets under our tax system.

The problem we have under present law is simply that passenger cars and light trucks are allowed inadequate depreciation deductions under both the alternative minimum tax and the regular income tax. These assets receive worse depreciation treatment than other business assets. This discrimination artificially increases the actual cost of these business assets, distorting business investment decisions and reducing the number of passenger vehicles purchased.

I am sure that it is difficult to understand how such an important part of our economy such as the automobile industry and passenger vehicles used in business has come to be treated so unfairly by our tax system. It may be helpful if I summarized some historical background on this issue.

Background

Automobiles have traditionally been depreciated over three years using a 200 percent declining balance method under the regular tax. This provided a modest amount of incentive depreciation consistent with the intent of regular tax depreciation. Unfortunately, in 1986, Congress lengthened the write-off period to five years, evidently based on a misapprehension of the useful life of these vehicles. This removed all incentive from regular tax depreciation.

The 1986 Tax Reform Act also included a corporate alternative minimum tax. Under the AMT, depreciation deductions were intended to approximate economic depreciation in the value of business assets, rather than to provide any incentive similar to that intended to be provided for regular tax depreciation. As a result, most assets were to be depreciated over a somewhat longer period using a 150 percent declining balance method. For business-use passenger vehicles, this period was set at the same five-year period provided under the regular tax, reflecting that the regular tax cost recovery period was longer than appropriate.

Treasury Department Study

Since 1986, it has been made absolutely clear that business-use passenger vehicles receive inadequate cost recovery treatment.

The Omnibus Budget Reconciliation Act of 1989 directed the Treasury Department to conduct a study of the proper class life of cars and light trucks. The Treasury Department issued a report in April, 1991, which recommended a class life of 3.5 years for business-use cars, and, in fact, concluded that the actual adjusted economic life for cars used in business fleets is 2.8 years.

The 1991 Treasury Department report is just the latest in a long line of Treasury determinations that cars should be depreciated over a 3-year period. The earliest determination was made in Bulletin F, an I.R.S. list of guideline lives for depreciable assets promulgated in 1942. In 1962, the Treasury Department issued new depreciation guidelines in Revenue Procedure 62-21 and once again provided for a 3-year class life for automobiles. Finally, in 1971, the Treasury Department issued new "asset depreciation range" ("ADR") guidelines which were based on the 1962 guidelines, but allowed taxpayers to select a class life within a 20 percent range around the mid-point life. Cars were assigned a mid-point class life of 3 years.

Absent legislation to the contrary, an asset with a 3.5 year class life would be treated as three-year property for tax purposes. However, the 1986 Act specified that passenger cars placed in service after December 31, 1986, and before January 1, 1992, were to be classified as five-year property. After that period, the Treasury Department was given the authority to reclassify cars and light trucks as appropriate.

Congressional Intent

It is important to highlight this point. When the cost recovery period for cars was lengthened to five years, Congress intended that the five-year write-off period was to be required only through 1991, presumably to balance revenues to the Treasury over that period. After 1991, the Treasury Department was given authority to reclassify cars as three-year property if it deemed the shorter period to be appropriate based on economic useful life of the asset.

Unfortunately, in 1988, Congress enacted legislation that removed the Treasury Department's authority to reclassify assets as appropriate. While that change was intended to keep Treasury from lengthening cost recovery periods for certain assets without clear Congressional direction, it had the effect of locking cars into an inappropriately long recovery period.

Shortening the cost recovery period for passenger vehicles would not be an incentive of some arbitrary amount, but would, rather, simply provide these assets with a cost recovery period that accurately reflects their usefulness in business. Nevertheless, shortening the cost recovery period to three years for business-use cars would also be one of the most effective and targeted tax incentives that the Government could provide.

AMT Depreciation

The 1991 Treasury Department report also makes absolutely clear that a five-year cost recovery period using the 150 percent declining balance method provides less than economic depreciation. Nevertheless, under present law, taxpayers are forced to use this five-year period for automobiles used in their business. This is absolutely contrary to the intent of the AMT to tax no more than economic income. Simple fairness would require that AMT depreciation be improved to reflect economic depreciation.

As I mentioned earlier, the Treasury Department's 1991 study concludes that an appropriate class life for business-use cars would be 3.5 years. Thus, the cost recovery period for cars under the AMT should be no more than 3.5 years to reflect economic depreciation, not the 5-year period provided under present law.

The economic effect of increasing the acceleration method for business-use passenger vehicles from 150 percent to 200 percent declining balance is equivalent to shortening the AMT cost recovery period for these assets from 5 years to 4 years. This would provide tax depreciation no greater than an approximation of the economic depreciation in the value of the assets.

I would like to thank the members of this committee for their efforts in repealing the ACE adjustment for depreciation under the AMT. That change was a substantial simplification. However, it is not an alternative to changing the acceleration method to 200 percent of the declining balance. Repealing the ACE adjustment did not provide business-use vehicles with economic depreciation and did not remove the discrimination against these assets as compared with other business assets.

We hope that, when you review requests for depreciation relief under the AMT, you will ask whether relief requested would provide simply economic depreciation or whether the requested relief would provide incentive depreciation. All we are asking is that we be allowed to deduct amounts which reflect the actual decline in the value of business assets. Increasing the acceleration method from 150 percent to 200 percent would accomplish this.

Economic Impact

In closing, I would like to emphasize the importance of this change to our country's economic well-being. More than 95 percent of business-use cars are products of domestic manufacturers. Over 125,000 businesses have fleets of ten or more automobiles. Business-use cars also account for over one-third of all automobiles sold by domestic manufacturers -- over 3.5 million cars per year.

Improving tax depreciation deductions directly reduces the cost of a vehicle. It is generally agreed in the industry that a reduction in price will result in an increase in sales of an equal percentage. In the business context, the increase in sales will occur both because businesses will operate more automobiles and because they will replace their fleets more often.

Thus, merely providing these vehicles with the depreciation rules which reflect economic reality will increase sales and result in more economic growth and more jobs, not only in automobile manufacturing directly, but also in industries such as steel, glass, rubber, textiles, and semiconductors that supply the automobile manufacturers.

For this reason we strongly urge that you adopt the proposal to provide for the use of 200 percent declining balance depreciation for passenger vehicles for alternative minimum tax purposes. We believe that the cost recovery period for these assets under the regular tax should also be reduced from five to three years, reflecting the results of the 1991 Treasury Department study. However, if revenue constraints require deferral of this proposal, you can be certain that the proposed change in AMT depreciation will have a real and important impact.

Chairman RANGEL. Independent Bakers, Dale Cox.

STATEMENT OF DALE COX, INDEPENDENT CONTRACTOR, SAN RAPHAEL, CALIF., ON BEHALF OF THE INDEPENDENT BAKERS ASSOCIATION; ACCOMPANIED BY ROBERT FANELLI, CHAIRMAN, INDEPENDENT CONTRACTORS COMMITTEE

Mr. COX. Thank you, Mr. Chairman. I am here today in support of the proposal by the baking industry for relief from the statutory employee rule. The statutory employee rule could place special and troublesome burdens on distributors of bakery products that essentially are not imposed on any other industry in America.

A recent change of interpretation of the statutory employee rule by the IRS threatens to destroy an opportunity that was available to me.

I would like to tell you a little bit about myself and what the opportunity to be an independent businessman has meant to me.

I was born and raised in California. I don't have a college degree, and with only a high school diploma spent the first decade of my adult life working as an employee in a job which offered little future beyond a weekly paycheck. In 1968, at the age of 31, I was fortunate enough to come across the opportunity to purchase a Pepperidge Farm Cookie territory in northern California for $5,000.

I was married and in those days $5,000 was an enormous amount of money. Even so, my young wife and I were determined to build a better life for our children and so, frightened to death, we bought the territory.

I thrived as a bakery distributor entrepreneur. For the first time in my life I was excited about my work, and while I routinely had to work 60 or more hours a week, those were happy times. The business was small and my resources smaller. My garage was my warehouse and at busy times of the year cartons of cookie inventory could be found in every nook and cranny of our home, where the kids quickly discovered that they could be stacked to make great play forts. Needless to say, all of the kids in the neighborhood wanted to play at our house.

The years of hard work and sacrifice paid off and my business grew and grew. Today I have 19 employees and my $5,000 original investment is worth well in excess of $1 million. It is a wonderful thing to have that kind of financial security, but the greatest joy for my wife and me has come from what it has enabled us to do for our family.

Our son, Russell, now 33, is active with me in the business and we work closely together on a daily basis. That is a joy every father should get to experience. Our daughter, Suzanne, who is 28, has graduated from Oregon State University and Dominican College with a teaching degree and is happily married to a good and able husband. We have four grandchildren so far and look forward to watching them grow and to being able to help them if they are ever in need.

It is doubtful that I could ever have had all these blessings unless that bakery distributorship had come into my life. The ability to act as my own boss, to market my products as I saw fit, and to have a financial reward for my hard work was a tremendous incentive. That incentive would have been lost if I were an employee, which is the likely result of applying the statutory employee rule in the manner recently put forth by the IRS. In terms of my success, that would have been tragic.

I understand that the matter of tax compliance generally is an ongoing concern of Congress. I appreciate that concern. I can tell you that in my years as a bakery distributor I have been careful to discharge my responsibilities as a taxpayer under the law. I want to assure the members of this subcommittee that if this proposal is adopted, I and the baking industry stand ready to assist the subcommittee to ensure compliance with the law.

I have attached to this written statement a copy of the statement submitted on behalf of the Independent Bakers Association. I completely endorse the IBA statement and ask that it be included in the record as part of my statement.

Thank you for the opportunity to appear here today and present these remarks.

[The prepared statement and attachment follow:]

STATEMENT ON BEHALF OF THE INDEPENDENT BAKERS ASSOCIATION AND THE BAKERY INDUSTRY IN SUPPORT OF THE PROPOSAL TO CLARIFY THE EMPLOYMENT TAX STATUS OF DISTRIBUTORS OF BAKERY PRODUCTS

Hearings on Miscellaneous Revenue Issues
Subcommittee on Select Revenue Measures
House Ways and Means Committee
September 8, 1993

Chairman Rangel and Members of the Subcommittee:

The Independent Bakers Association appreciates the opportunity to present its views and the views of the bakery industry on the proposal by Congressman Sundquist to amend IRC § 3121(d)(3)(A) relating to the employment tax status of bakery distributors. We would like to thank Mr. Sundquist for his strong support for this proposal.

Description of the Issue

The issue before the Subcommittee is whether bakery distributors should be classified by statute as employees for employment tax purposes even though they may be treated as independent contractors for income tax purposes. Our proposal (which is attached to this statement as Exhibit 1) would delete the phrase "bakery products," from section 3121(d)(3)(A) of the Code. Section 3121(d)(3)(A) presently provides that certain distributors, including bakery distributors, will under certain circumstances be treated as employees for employment tax purposes.[1]

We believe it is important to clarify for the Subcommittee what this proposal will and will not do. The proposal under consideration today does not seek to classify bakery distributors as independent contractors.[2] Neither does it seek to change in any way the common law test by which individuals are classified as either employees or independent contractors. The proposal would simply eliminate the irrebuttable presumption that bakery distributors are employees for employment tax purposes and would place them on the same footing with other individuals by making distributors subject to the same common law test for employment status as everyone else.

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[1] Section 3121(d)(3)(A) provides:

(d) EMPLOYEE.--For purposes of this chapter, the term "employee" means--

(1) ...; or

(2) ...; or

(3) any individual (other than an individual who is an employee under paragraph (1) or (2)) who performs services for remuneration for any person--

(A) as an agent-driver or commission-driver engaged in distributing meat products, vegetable products, bakery products, beverages (other than milk), or laundry or dry-cleaning services, for his principal;

(B) ...;

(C) ...; or

(D) ...;

if the contract of service contemplates that substantially all of such services are to be performed personally by such individual; except that an individual shall not be included in the term "employee" under the provisions of this paragraph if such individual has a substantial investment in facilities used in connection with the performance of such services (other than in facilities for transportation), or if the services are in the nature of a single transaction not part of a continuing relationship with the person for whom the services are performed; or

(4) ....

Section 3121(d)(3)(A) overrides the normal, common law test for employment status; thus, even though a bakery distributor would be treated as an independent contractor for income tax purposes, if that person falls under section 3121(d)(3)(A), he or she will nevertheless be considered an employee for employment tax purpose.[3] We contend that this treatment as statutory employees is completely inappropriate in light of the way in which the bakery industry is organized. Classifying bakery distributors as statutory employees is disruptive of sound business arrangements, is technically unworkable, and serves no identifiable tax or retirement policy goal. Current law discriminates against distributors by creating an irrebuttable presumption that they are employees for employment tax purposes even though they may be independent contractors for income tax purposes.

History of the Statutory Employee Provision

Section 3121(d)(3)(A) was enacted in 1950, at a time when the combined FICA tax rate for employees was higher than the tax on self-employed individuals.[4] Section 3121(d)(3)(A) was enacted as remedial legislation. Congress concluded that "the usual common-law rules for determining the employer-employee relationship [fell] short of covering certain individuals who should be taxed at the employee rate under the old-age, survivors, and disability insurance program."[5] Congress apparently concluded that it was important to secure for distributors the higher Social Security benefits that would accrue to them as a result of the higher tax rates.

While originally drafted to apply to house-to-house sales persons, the language eventually enacted referred to individuals distributing certain goods and services, such as bakery, meat, vegetable and beverage products, and laundry and dry cleaning services.[6] The statute excepted from its coverage individuals who had a substantial investment in facilities used in connection with the performance of such services (other than in facilities for transportation).[7]

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[2] The announcement for today's hearing described the proposal as one to "eliminate the rule treating distributors of bakery products as statutory employees for purposes of Social Security payroll taxation and coverage, and to treat such persons as independent contractors." This is technically not correct. While the proposal does eliminate the rule classifying bakery distributors as statutory employees, it does not classify them as independent contractors. It merely leaves these individuals subject to the normal, common law test for employment status.

[3] Section 3121(d)(3)(A) classifies certain driver-distributors as employees for employment tax purposes. It was made applicable to the unemployment tax in 1972. See IRC § 3306(i). It has no application or effect on their classification for income tax purposes.

[4] In 1950, the combined FICA tax rate for employees was 4% while the tax on self-employed individuals was 2.25%. The "combined" FICA tax rate for employees is the sum of the equal taxes paid by employers and employees on wages paid to the employee.

[5] See Senate Report 1669, 81st Cong., 2d Sess. 144 (1950).

[6] Indeed, the legislative history of the statute is replete with references to house-to-house sales.

It is apparent that the world has changed dramatically from the time the statute was enacted in 1950. Door-to-door deliveries of bread, milk and cakes have long since gone the way of the dinosaur.[8] Today, local bakeries have disappeared, having been consolidated into regional and national concerns. Bakery products are no longer sold door-to-door. Instead, these products are often distributed by individuals owning their own territories, who purchase their products directly from the bakeries, and who distribute the products to commercial customers (such as grocery stores and restaurants) for resale.

More important still is the change in the respective tax rates for employees and self-employed individuals. As previously discussed, the combined FICA tax rate for employees in 1950 was 4 percent while the tax rate on self-employed individuals was 2.25 percent. In 1984, these tax rates were equalized.[9] Today, both the self-employed tax rate and the combined FICA tax rate stand at 15.3 percent. Therefore, the primary reason for the enactment of the statutory employee rule -- the higher tax rate for employees and the higher benefits derived from that higher tax rate -- no longer exists. Section 3121(d)(3)(A) is an anachronism in today's world.

Why Is The Statutory Employee Issue Important Today?

Some members of the Subcommittee may wonder why this issue is so critical in 1993 when the statute has been in effect since 1950. The answer is simple. For many years the bakery industry considered section 3121(d)(3)(A) inapplicable to most distributors. It was not until 1991, when the Internal Revenue Service issued GCM 39853, that the industry's long-held view was called into question.

As previously discussed, the statute provides an exception where the individual has a "substantial investment in facilities." Throughout the years, many bakery distributors have purchased their territories from the bakeries or from the previous owners of the territories. The distributor's ownership of the territory has been consistently interpreted as a substantial investment in facilities, thus exempting the distributor from the statutory employee provision.[10]

This interpretation of the substantial facilities exception was never, to anyone's knowledge, challenged by the Internal Revenue Service on audit. Indeed, in 1985, the Internal

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[7] The statute also provides an additional exception in cases where the contract contemplates that substantially all of such services shall be performed personally by such individual.

[8] Throughout the 1940s and 1950s, bakeries were essentially local operations. Bread and layer cakes were baked daily and delivered to the homes of customers. These products were typically sold by individuals who used delivery vehicles to cover certain neighborhoods or routes. The vehicles used may or may not have been owned by the individuals. Similarly, meat and vegetable products were sold off of vehicles making house-to-house deliveries. Milk was also delivered house-to-house, although dairy products were excepted from the final version of the bill without explanation. Finally, laundry services were typically provided on a house-to-house basis.

[9] See Social Security Amendments of 1983, P.L. 98-21, section 123.

[10] It should be noted that many distributors have substantial investments in equipment in addition to their investment in their territories.

Revenue Service concluded in a technical advice memorandum that investment in a territory constituted a substantial investment in facilities.[11] It was not until that technical advice memorandum was withdrawn in 1988 and the IRS, in 1991, released General Counsel Memorandum 39853 that the issue became one of concern to the bakery industry.

GCM 39853 takes the position that the term "facilities" in section 3121(d)(3)(A) does not include distribution rights, such as a territory. Ironically, the Internal Revenue Service has never sought to enforce the position taken in the GCM by means of an audit or through litigation. The GCM stands as the sole pronouncement of the IRS position on this issue.

There is serious doubt that the GCM is correct. Its reasoning is questionable, its logic weak and its timing (41 years after the statute was passed) is suspect.[12] It is the undisputed opinion of tax advisors to the bakery industry that the position taken in the GCM would not prevail in court if the issue were litigated. Nevertheless, the uncertainty that the GCM has created among members of the industry makes legislative action to clarify the issue imperative.

Effect on the Bakery Industry

1. Technical Problems

Application of the statutory employee rules to bakery distributors would create numerous technical difficulties. First, the distributor would be required to compute his or her income two different ways -- once as an employee and once as a self-employed individual -- since certain expenses are deductible for self-employed individuals but not for employees. The absurdity of requiring two sets of books for the same person, especially a small business person, is self-evident.

Second, if the bakery is required to treat the distributor as an employee, what amount does the bakery report to the distributor and to the IRS as wages paid? Bakeries sell their products to distributors. The distributor then resells the product to the market or other establishment. The distributors income is the profit made from this resale. The bakery has no information about the profit the distributor has made. If the bakery were to report the price paid by the distributor for the product, that would grossly overstate the amount of income actually earned by the distributor. It would totally fail to take into account the purchase cost of the products and any of the distributor's expenses (such as fuel, marketing costs, wages paid to the distributor's employees, etc.), as well as any discounts or allowances given to the distributor's customers directly by the distributor.

The distributor system, as it has evolved through the years, bears no resemblance whatsoever to a wage-based compensation system. The industry would be forced to completely restructure itself in order to comply in any meaningful way with the statutory employee rule. The costs of this restructuring would be wholly disproportionate to the benefit (if any) derived.

Finally, classification of distributors as statutory employees is particularly confusing in light of the fact that many distributors have their own employees and operate in corporate form. In particular, distributors with large, heavily populated or prosperous territories may have several employees of their own.

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[11] See TAM 8607001.

[12] For example, the GCM argues that distribution rights (such as a delivery territory) are more akin to education, training and experience because all are intangible. Unlike education, training and experience, however, distribution rights are assets that are readily transferable and that have a value in the market place that is affected by the skill and industry of the distributor.

Many questions arise as to how the employees of the distributor are to be treated. A few of those questions include: (1) Will they be considered employees of the distributor or the bakery? (2) If the latter, how will that affect their treatment by the bakery for income tax purposes. (3) Are these employees of the distributor eligible for benefit plans maintained by the bakery? (4) If they are not treated as employees of the bakery, are their wages deductible for purposes of computing the FICA tax on the distributor's income.

This last question points out the strange consequences of applying the statutory employee rule to bakery distributors. If the distributor is treated as an independent contractor, wages paid to the distributor's employees are deductible in computing the distributor's self-employment tax. However, these wages are not be deductible by the distributor if he or she is treated as an employee. The result is that the wages paid to the distributor's employees is subject to double FICA tax: once by the bakery and the distributor (because these wages are not deductible in computing the distributor's wages) and once by the distributor and his or her employee. Without question, this is the wrong outcome. Yet it would be required if the statutory employee rule applies.

The result is even more egregious under the recently-passed Omnibus Budget Reconciliation Act of 1993. Before passage of the Act, there was a cap on the wages or self-employment income subject to FICA or self-employment tax.[13] Section 13207 of the Act repealed the cap on amounts subject to the hospital insurance portion of the employment tax (now equal to 2.9 percent) beginning in 1994. Thus, where the damage done by the statutory employee rule was once mitigated by the wage cap, that cap as now been removed, at least for purposes of the HI tax.

It is not difficult to see that application of the statutory employee rule to bakery distributors creates bizarre results. Without any policy rationale remaining to support its existence, this potential for bizarre results is a compelling reason to eliminate the rule.

2. Effect on Entrepreneurship

The eventual outcome of applying the statutory employee rule to the bakery industry is likely to be a complete restructuring of the industry. A part of that restructuring will no doubt be a severe cutback on the use of independent bakery distributors. Such a result would be truly unfortunate in view of the benefits that the industry (both the bakeries and the distributors themselves) has gained from their use.

Application of the statutory employee rule would deny an entrepreneurial opportunity to those individuals desiring to operate a wholesale distributorship business. Independent wholesalers have significant opportunities to develop a successful distributorship and earn profits substantially greater than the salaries that would be paid to employees. In addition, if the distributor owns his or her distribution rights, the distributor has the opportunity to build the value of the distributorship that he or she may eventually sell for a greater profit. All these incentives are lost, however, if the distributor cannot be an independent wholesaler.

Moreover, application of the statutory employee rule to existing ownership arrangements would substantially undermine the value of the distributorships already in place. The value of these existing arrangements was premised on an assumption of independent contractor status. Application of the statutory employee rule would severely lower those values to the detriment of the distributors owning distribution rights.

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[13] For 1993, the caps were 57,600 for the OASDI portion of the tax and 135,000 for the HI portion of the tax.

Conclusion

It is understandable that Congress would seek to prevent abuses in the employment tax system that can occur from classification of an individual as an independent contractor rather than an employee. However, the bakery distributor system is not riddled with those abuses. Even if the system were, however, application of the statutory employee rule is clearly the wrong answer to the problem. Indeed, its application would create far more problems than it would solve. For all the reasons stated above, we urge the Subcommittee to endorse the proposal of the Independent Bakers Association to repeal the rule with respect to bakery distributors.

Thank you very much, Mr. Chairman.

EXHIBIT 1

SEC. XXX. CLARIFICATION OF SELF-EMPLOYMENT STATUS OF CERTAIN BAKERY DISTRIBUTORS.

(a) In General.--Subparagraph (A) of section 3121(d)(3) (relating to the definition of employee for employment tax purposes) is amended by striking "bakery products,".

(b) Effective Date.--The amendment made by this section shall take effect on the date of enactment of this Act.

Chairman RANGEL. Thank you.

Next is Fred Lazarus, the Association of Independent Colleges of Art and Design.

STATEMENT OF FRED LAZARUS IV, VICE PRESIDENT, ASSOCIATION OF INDEPENDENT COLLEGES OF ART AND DESIGN

Mr. LAZARUS. Mr. Chairman, members of the committee, thank you for allowing me to testify today. I am here representing the Association of Independent Colleges of Art and Design. These 30 colleges are major sources of designers throughout this country and employ thousands of designers and artists on their faculties. They include institutions that range on the West Coast from the Arts Center in Pasadena to Parsons School of Design and the School of Visual Arts in New York City. All of these are leaders in their field producing the leading industrial designers in the automobile industry, fashion designers, and graphic designers. There are dozens of these institutions throughout this country.

We are here today asking your committee to correct what we believe was an oversight of the 1986 Tax Reform Act. That bill under section 170(e)(4) provided companies who contributed equipment to colleges and universities a greater level of deductibility for gifts made for the purposes of the physical and biological sciences. This section encouraged many gifts, enhanced research at these colleges and universities, and is helping this Nation enhance its competitiveness through the work being done by these colleges and universities.

The section does not allow the same level of deductibility for contributions of equipment used in the fields of design. It is particularly discriminatory to colleges that do not have physical or biological sciences. Colleges such as ours, which do not have these departments, are excluded from these gifts and are not able to receive the benefits that our colleagues in other colleges and universities have. However, the contribution that these colleges are making to the fields of design and to the competitiveness of this country are more substantial than all these other institutions. The financial impact of this modification in the bill would be negligible, and the impact would be very significant. It would enhance research and development in the field of design, and we hope we would have your support for this change in section 170(e)(4) of the bill. Thank you very much.

Chairman RANGEL. Thank you.

[The prepared statement follows:]

TESTIMONY FOR THE MODIFICATION OF THE INTERNAL REVENUE CODE OF 1986

September 8, 1993

Submitted by Fred Lazarus, President, Maryland Institute, College of Art, on behalf of the Association of Independent Colleges of Art and Design

Mr. Chairman and Members of the Committee. Thank you for inviting the Association of Independent Colleges of Art and Design to testify before you today.

The Association of Independent Colleges of Art and Design is an organization representing virtually every art and design college in the country. These colleges employ thousands of artists and designers and include among their alumni the finest artists and designers in this country.

We come before you to request your help in correcting an oversight in the 1986 Internal Revenue Code which we believe, if changed, will help enhance the competitiveness of American industry.

The 1986 Internal Revenue Code, under Section 170(e)(4), provides for a greater level of deductibility for contributions of scientific property used in research activities by educational institutions. However, for the gift to qualify, the property donated must be scientific equipment used for research or experimentation or for research training in the physical or biological sciences.

This provision in the tax code has resulted in millions of dollars worth of critical equipment being donated to colleges and universities which offer degrees in the physical or biological sciences and do research in these fields. The rationale for this tax provision has been that this research has a direct impact on the United State's economic competitiveness. The Ways and Means Committee Report stated, as part of its rationale, that studies indicate that in equipment-intensive research areas, such as physics, chemistry, and electrical engineering, the continuing growth of university expenditures has not kept pace with the rising costs of scientific instrumentation. The budget impact of this change was estimated to be $5 million.

The same rationale that caused the Congress to recognize the importance of providing a greater level of deductibility for contributions of equipment for the biological and physical sciences can and should be applied to design and design theory. America's competitiveness not only depends upon scientific research but also on the quality of design of our products. The design process 15 to 20 years ago required a minimum of equipment. Today, that has changed. Design today has become an equipment-intensive area of research and study.

The design colleges and university design departments are the country's major source of talent and know-how in the automotive and product design fields, and fashion and in film. However, there is a growing list of other product areas that draw upon the design work of these colleges and universities. These fields include: computer graphics; computer animation; image processing; scientific and ~~medieval~~ medical visualization; object, product, process simulation and dimensional modeling; image modification and storage; interactive digital television; typography and letter design and image and photo screening.

Most of these applications are parts of the film, print and graphics, and electronic imagery industries. These are huge industries where our competitiveness is being threatened. However, even more important to our economy is the impact these industries and processes have on other product areas and manufacturing.

Colleges and universities, particularly the specialized colleges of art and design which produce most of our leading designers, do not have the resources to provide their faculty and students with the equipment that is now available. Much of the research that is needed to determine how to use and apply this equipment to the needs of the design fields is not being developed because of the lack of monetary resources in the colleges and universities.

The current language in the tax code precludes equipment manufacturers from contributing equipment to colleges where the intent of the donee is to use the equipment to advance design theory or develop new concepts and uses of design. This impediment has reduced the rate of progress in design research at the college and university level and caused design training to lag behind.

This is a request made on behalf of the members of the Association of Independent Colleges of Art and Design to modify the current IRS Code to include Design and Design Theory within the definition of allowable research, experimentation, and research training in Section 170(e)(4).

Chairman RANGEL. Mr. Rosenkranz, counsel, University of Florida Health Center.

STATEMENT OF STANLEY W. ROSENKRANZ, GENERAL COUNSEL, FLORIDA CLINICAL PRACTICE ASSOCIATION, INC.; AND SPECIAL COUNSEL, UNIVERSITY OF FLORIDA AGENCY, AND UNIVERSITY OF SOUTH FLORIDA COLLEGE OF MEDICINE'S FACULTY PRACTICE PLAN

Mr. ROSENKRANZ. Good morning, Mr. Chairman, and members of the subcommittee. Our law firm is general counsel to the Florida Clinical Practice Association, a section 501(c)(3) Florida not-for-profit corporation, and special counsel both to the University of South Florida College of Medicine practice plan and the University of Florida agency funds.

The Florida Clinical Practice Association I will refer to as the FCPA and the agency funds as the University Fund. I appear today on behalf of our clients to support the enactment of a proposed amendment to section 125(a) of Public Law 98–21, which I will refer to as section 125.

While our firm does not represent the board of regents of the State of Florida, I have been authorized to say the proposed amendment has the full and enthusiastic support of the board's chancellor. Section 3121(s) of the code speaks to FICA responsibility when two or more related corporations concurrently employ the same individual. Section 125 under certain circumstances treats as related corporations for purposes of section 3121(s) a State university, which employs health professionals at a medical school, and a faculty practice plan, which employs faculty members of such medical school.

Section 125, however, requires employment by the practice plan. To do so in Florida, which has broadly retained the doctrine of sovereign immunity, would expose faculty members at the Health Science Center and the respective practice plans to severe liability for medical malpractice claims. For multiple reasons, some of which will be discussed later, including accommodating the instant situation, moneys are transferred to the University Fund. From the University Fund from time to time, a check is drawn in part payment of the compensation agreed to in the sole contract of employment.

As currently required by the Internal Revenue Service and currently the subject of controversy between the college and the Internal Revenue Service, the University Fund pays FICA as if it were the sole employer. The result, a single contract of employment, two checks in payment of the compensation required by the single contract of employment, double employer share of FICA with no automatic refund mechanism, double employee share of FICA with an automatic refund provision, two form W–2s and two form 941s.

Our written statement cites both letter and published rulings indicating that the existence of two taxpaying entities having two taxpayer identification numbers and each filing separate W–9s and Form 941s is not unknown to the Internal Revenue Service.

In short, the Internal Revenue Service is familiar with dual payer situations such as that for which we contend. Moreover, in the world of computers it should be a situation of no moment. The proposed legislation will merely allow the intended result provided by section 125 a provision not practically available to the various health professional colleges at the University of Florida Health Science Center or the University of South Florida. The proposed amendment postulates a position that is supported by an American Association of Medical College letter that will be submitted for the record.

It is also supported, Mr. Chairman, by a letter to you signed by all members of the Florida Delegation, Democrat and Republican. Based on our informal survey of other medical schools in this situation, it would appear that the revenue impact should be limited to the employer's share of FICA that would otherwise be paid by the agency funds at the University of Florida and the University of South Florida. Thus, we estimate that the impact would not exceed $3 million a year. These dollars would, of course, otherwise be available to support academic and research activities and the provision of health care services to both categorically and medically indigent patients.

The essence of the matter before this subcommittee is the payment of double FICA by respective agency accounts at the universities in Florida. The situation is caused by, one, the inability of the agency funds to utilize section 125 because neither is a practice plan and an employer and, two, the inability of our clients to convince the Comptroller of the State of Florida, a constitutional officer of the State of Florida, to agree to effect payment of faculty compensation in a manner that would obviate the need for legislation.

At a meeting with a member of the staff of the House Ways and Means Committee's Subcommittee on Social Security, amplification of this point was requested. As we attempted to prevent the double FICA situation, an obvious solution suggested itself. In lieu of multiple payments due under a faculty member's single contract of employment, such payment would be effected solely through the Office of Comptroller of the State of Florida.

In an attempt to effect such an arrangement, negotiations over a protracted period of time were carried on with top officials of the Comptroller's office. In addition to members of the staff of one of the universities, as well as assorted legal counsel, the meetings were attended by either the chancellor of the Florida system or one of the vice chancellors. Three major concerns evolved.

One, when would the money become State funds if transferred to the Comptroller and what would be the legal ramifications if the funds were deemed to be State funds. The thought was that a marked actuarial adjustment under the Florida retirement system would be required. Having then just recently suffered the economic consequences of such a readjustment, $6 to $7 million, the University of Florida College of Medicine was less than enthusiastic concerning such a possibility.

The second problem was nonacademic intrusion into the academic decisionmaking process. This question is particularly pertinent in the State of Florida, a State where the university system has been historically subject to the micromanagement proclivities of both the legislative and executive branches of the State government.

At the University of Florida, practice plans contribute 52 percent of the College of Medicine's budget, and at the University of South Florida 55 percent of the College of Medicine's budget. Given such facts, the chancellor, along with the academic leadership, felt it most important to ensure academic control and oversight by mandating that these funds be retained in a university agency account, thereby assuring continued university oversight.

The final problem was loss of flexibility in connection with fixing the compensation of the clinical faculty. At a time when the health care system is undergoing tremendous change, particularly as regards physician compensation, the prospect of such loss of flexibility was of grave concern. It was felt that the health care delivery system environment mandated afforded each college of medicine flexibility as to the compensation to be paid to members of the clinical faculty staff, neither party being able to assuage the other's concerns at the termination of the negotiations. The chancellor concluded that it was not possible to frame a solution that adequately addressed the concerns of each of the involved parties.

Thank you, Mr. Chairman.

[The prepared statement follows:]

WRITTEN STATEMENT OF STANLEY W. ROSENKRANZ OF SHEAR, NEWMAN, HAHN & ROSENKRANZ, P.A., GENERAL COUNSEL TO FLORIDA CLINICAL PRACTICE ASSOCIATION, INC., A FLORIDA NOT FOR PROFIT CORPORATION AND SPECIAL COUNSEL TO THE UNIVERSITY OF FLORIDA AGENCY FUNDS AND THE UNIVERSITY OF SOUTH FLORIDA COLLEGE OF MEDICINE'S FACULTY PRACTICE PLAN SUBMITTED IN SUPPORT OF A PROPOSED AMENDMENT TO SECTION 125(a) OF P.L. 98-21 (THE "PROPOSED LEGISLATION")

PROPOSED LEGISLATION

Section 3121(s) of the Internal Revenue Code of 1986, as amended (the "Code") speaks to "FICA responsibility" when two or more related corporations concurrently employ the same individual compensated through a common paymaster which is one of such corporations. Section 125(a) of Public Law 98-21 (the "Special Act"), under certain circumstances, treats as related corporations for purposes of that Code section, a state university which employs health professionals at a medical school and a faculty practice plan which employs faculty members of such medical school.

The Proposed Legislation would amend the Special Act as follows:

"Sec. 125(a) of P.L. 98-21, TREATMENT OF CERTAIN FACULTY PRACTICE PLANS OR UNIVERSITY ACCOUNTS.

"(a) General Rule -- For purposes of subsection (s) of Section 3121 of the Internal Revenue Code of 1954 (relating to concurrent employment by 2 or more employers) --

"(1) the following entities shall be deemed to be related corporations that concurrently employ the same individual:

"(A) a State university which employs health professionals as faculty members at a Health Science Center that includes a College of Medicine, and one or more of the following: a College of Dentistry, a College of Public Health, a College of Nursing, a College of Veterinary Medicine, a College of Health Related Professions, or a College of Pharmacy, and either

"(B) a faculty practice plan described in section 501(c)(3) of such Code and exempt from tax under section 501(a) of such Code --

"(i) which employs faculty members of such medical school, and

"(ii) 30 percent or more of the employees of which are concurrently employed by such medical school; or

"(C) an agency account of a State university which is described in (a)(1)(A) of this section and from which there is distributed to faculty members of any of the colleges described in (a)(1)(A) of this section, payments forming a part of the compensation the State, or such State university, as the case may be, agreed to cause to be paid any such faculty member, and

"(2) remuneration which is disbursed by either:

(A) such faculty practice plan to a health professional employed by both of the respective entities referred to in paragraph 1(A) and (B) of this section; or

(B) such agency account to a faculty member of any of the Colleges described in (a)(1)(A) of this section

shall be deemed to have been actually disbursed by the State, or such State university, as the case may be, as a common paymaster and not to have been actually disbursed by such faculty practice plan or agency account, as the case may be.

"(b) Effective Date --"

The need for the Proposed Legislation emanates from the unique manner in which compensation is paid certain members of the respective faculties at the University of Florida (the "University") Health Science Center in Gainesville, Florida and at the University of South Florida in Tampa, Florida ("USF").

Based on our informal survey of medical schools, it would appear that the revenue impact of the Proposed Legislation would be limited in scope. More particularly, the revenue impact should be limited to the employer's share of FICA that would otherwise be paid by the agency funds at the University of Florida and the University of South Florida. Assuming (i) a constant FICA tax rate and (ii) no dramatic increase in faculty compensation, it is estimated the annual revenue impact would be less than $3 million. These dollars would otherwise be available to support (i) the respective medical colleges' academic and research activities and (ii) the delivery of health care services to indigent and underfunded patients.

FACTUAL BACKGROUND

As an integral part of their respective University teaching or research activities, or both, members of the respective faculties of the University's College of Medicine, College of Dentistry and College of Health Related Professions (singularly, a "College" and collectively, the "Colleges") generate patient fees (collectively, the "Fees"). The same would hold true for faculty members of USF's College of Medicine.

Pursuant to rules of the Board of Regents of the State of Florida (the "Board"), each such faculty member, as a condition of employment by the respective colleges, agreed that all Fees generated by his/her faculty activities will belong to and be deposited into the practice plan created by his/her respective College. There is no employment relationship between any faculty member and any practice plan.

The Florida Clinical Practice Association, Inc., a Florida Not for Profit Corporation, which is exempt under section 501(c)(3) of the Code (the "FCPA"), is the repository of all patient fees generated by clinical activities of any member of the faculty of the University's College of Medicine. From time to time, subsequent to collection of the Fees by the FCPA or any other practice plan, a substantial portion of such plan's monies are deposited into an identifiable account within the University of Florida agency funds (the "University Fund"). The latter, itself, is merely a statutorily authorized bank account outside of the State Treasury. The FCPA also collects a portion of the patient fees generated by the activities of faculty members of the University's College of Health Related Professions, all of which fees it deposits in the University Fund. The University's College of Dentistry effects a direct collection of fees generated by its faculty members. All of such fees are deposited into the University Fund.

The monies in the respective practice plans are used to support (i) the educational and research activities of the respective Colleges and (ii) the delivery of health care services to indigent and to underfunded patients. Indeed, the FCPA, the University's College of Medicine's practice plan, provides approximately fifty-two percent of that College's entire budget.

Additionally, on a continuing basis, the assets of a particular practice plan are the means by which a significant capital project can be undertaken by the University. As an example, the FCPA's gross revenues are the main source of security for the bonds from the sale of which emanated the capital to build and equip an academic research building at the University's Health Science Center.

Each faculty member is employed by his/her respective College pursuant to a single contract of employment. Pursuant to pertinent rules of the Board, the compensation provided for in such contract is approved annually by (i) the Dean of the respective College, (ii) the University's Vice President for Health Affairs, and (iii) the President of the University. Pursuant to the single contract of employment, each faculty member is compensated for services rendered in his/her role as a teacher for both his/her teaching duties and for health care services provided individuals concomitant to those teaching responsibilities. For a substantial portion of the pertinent faculty members, payment of total compensation is effected in the form of two documents: a warrant from the State Treasury and a check from the University Fund. The pertinent compensation payments from the University Fund represent a procedure of paying such faculty member's compensation with both State and University Fund provided monies.

As noted, a faculty member is employed by the University pursuant to a single contract of employment. For this reason, the Special Act, which contemplates a duality of employers, is of no benefit in this situation. Accordingly, by reason of such compensation payments, the State and the University Fund, for its respective component of such member's compensation, each issues a Form W-2 to each faculty member whose total compensation is fixed and paid as indicated in the first and last sentences of the prior paragraph, respectively. The State and the University Fund have separate federal taxpayer identification numbers. Utilizing its own respective taxpayer identification number, the State and the University Fund each also files a Form 941.

The State, by reason of its "Section 218 Agreement", pays employer FICA taxes and withholds employee FICA taxes on that portion of the wages paid directly by the State to each affected faculty member. In effecting compensation payments on behalf of each of the Colleges, the University Fund, as required by the Internal Revenue Service, also pays employer FICA taxes and withholds employee FICA taxes as if it were an employer and as if the State had not caused FICA payments to be made. (This situation is presently the subject of a controversy between the University Fund and the Internal Revenue Service.) Such is the case despite the fact neither the State, the University, any of the Colleges nor the University Fund deem the University Fund, a mere bank account, a separate employer. Indeed, an appellate court in Florida has held that such a fund is not an employer. See, Bryant v. Duval County Hospital Authority, et al, 459 So. 2d 1154 (Fla. Dist. Ct. of App, 1984).

The essence of the matter before the House Ways and Means Committee's Subcommittee on Select Revenues is the payment of "Double FICA" by respective agency accounts at the University of Florida (Gainesville, Florida) and the University of South Florida (Tampa, Florida). The situation is caused by the inability (i) of the agency funds to utilize Section 125(a) of Public Law 98-21 because neither is a practice plan and an employer and (ii) of the Comptroller of the State of Florida (a constitutional officer) to agree to effect payment of faculty compensation in a manner that would obviate the need for legislation. At a meeting with a member of the staff of the House Ways and Means Committee's Subcommittee on Social Security, amplification of point (ii) was requested.

As the agency accounts, particularly the University of Florida Agency Fund, attempted to prevent the "double FICA" situation, an obvious solution presented itself. In lieu of multiple sources effecting payment of the compensation due under a faculty member's single contract of employment, such payment would be effected solely through the Office of the Comptroller of the State of Florida (the "Comptroller").

In an attempt to effect such an arrangement, negotiations over a protracted period of time were carried on with top officials of the Comptroller's Office. In addition to members of the staff of one of the involved universities, as well as assorted legal counsel, the meetings were attended by either the Chancellor of Florida's State University System (the "Chancellor") or one of the Vice Chancellors.

No mutually satisfactory agreement could be reached with the Comptroller. Among the many concerns expressed and vigorously discussed were the following:

1. When, if at all, would the money transferred to the Comptroller by the respective Agency Fund become "state funds"? What legal ramifications would result?

   If the funds were to be deemed "state funds", the thought was that a marked actuarial adjustment under the Florida Retirement System would be required. Having just recently suffered the economic consequences ($6 to $7 million) of such a re-adjustment, the University of Florida College of Medicine was less than enthusiastic concerning such a possibility.

2. Non-academic intrusion into the academic decision making process.

   The question is particularly pertinent in the State of Florida. Historically, the State's university system has been subjected to the micro management proclivities of both the legislative and executive branches of State government. At the University of Florida, faculty practice plan funds represent approximately fifty-two percent (52%) of its College of Medicine's budget, while at the University of South Florida, fifty-five per cent (55%) of its College of Medicine's budget. Given such facts, the Chancellor, along with the Academic leadership, felt it most important to ensure academic control and oversight by mandating funds be placed in an agency account, thereby, in turn, assuring continued University oversight.

3. Loss of flexibility in connection with fixing the compensation of clinical faculty. At a time when the health care system is undergoing tremendous change, particularly as regards physician compensation, the prospect of such loss of flexibility was of grave concern. The health care delivery system environment mandated, it was felt, affording a College of Medicine increased flexibility as to the compensation to be paid to members of its clinical faculty staff. It was thought that this important flexibility element would be markedly compromised if funds were deposited with the Comptroller.

At the termination of these negotiations, the Chancellor concluded that it was not possible to frame a solution that adequately addressed the concerns of each of the involved parties. Accordingly, it was impossible to arrange for compensation to be paid from one source.

AUTHORITIES

In other situations, such duality of the source of compensation has not prevented a result similar to the result that the Proposed Legislation would provide. For example, the Regulations promulgated under Section 218 of the Social Security Act indicate that

> "(W)here an individual in any calendar year performs covered services as an employee of a State and as an employee of one or more political subdivisions of the State, or as an employee of more than one political subdivision; and the State provides all the funds for the payment of the amounts which are the equivalent to the taxes imposed on the employer under FICA on the individual's remuneration for services; and no political subdivision reimburses the State for paying those amounts; the State's agreement or modification of an agreement may provide that the State's liability for the contributions on that individual's remuneration shall be computed as though the individual had performed services for only one political subdivision. The State may then total the individual's covered wages from all these governmental employers and compute contributions based on that total, subject to the wage limitations in Section 404.1047." See Regulation Section 404.1256.

The University Fund, of course, being a mere bank account, cannot be considered a political subdivision for purposes of the foregoing.

Acceptance of the dual source of funds concept is also suggested by Code Section 3121(u)(2)(D) which specifically states that all agencies and instrumentalities of a single state shall be treated as a single employer. This language manifests recognition that where an employee of a state performs services for more than one agency or instrumentality of that state then such service will be viewed as services for a single employer. This section recognizes the singularity of the employment relationship and limits the state's liability to a single wage base for each of its employees for all agencies and instrumentalities.

A similar view that dual sources of funds, by themselves, should not prevent the existence of a single employer is also suggested by the legislative intent indicated in the Senate Bill Report for the Special Act. That law amended Code section 3121(b) and (s) to include a provision applicable when a state university employs health care professionals at a medical school and a tax-exempt faculty practice plan employs a significant percentage of those same physicians. Given such a situation, the Special Act mandates that the disbursements by the faculty practice plan are to be deemed to be actually disbursed by the university. Thus, the singularity of the employment relationship is clearly recognized and is deemed to require a single calculation of the wage base. In short, the Special Act provides that remuneration disbursed by the faculty practice plan to a health professional employed both by the plan and the university, will be deemed "to have been actually disbursed by such university as a common paymaster and not to have been actually disbursed by such faculty practice plan." Result: one FICA tax payment, in a situation in which there is clearly two separate employers. This is to be distinguished from the University's situation which involves one employer hiring each of its faculty members pursuant to a single contract of employment and compensating such faculty members from two sources.

That the existence of two paying entities could give rise to a situation involving two taxpayer identification numbers should be of no significance. A review of Private Letter Rulings makes it at once apparent that such a situation is not unknown to the Internal Revenue Service. Private Letter Ruling 6609164800A (the "Letter Ruling"), for instance, contemplated a situation involving two separate corporations, A and B, each having its own taxpayer (employer) identification number, which operated under a joint contract. Under the contract, all employees performed duties for both corporations. Only Corporation A, however, filed employment tax returns.

Addressing the question as to which corporation had the responsibility for filing such returns, the IRS determined that the two entities were truly distinct employers and therefore, each should file Forms 941 and 940. However, for those years which corporation B, had failed to collect, report and pay FICA employee tax, it was relieved of doing so, since corporation A had already reported and paid the requisite amounts. In order to satisfy the IRS, corporation B simply attached a supporting statement to its employment tax returns, setting forth the entire factual situation, that is, that FICA taxes had previously been paid by corporation A.

Rev. Rul. 57-22, 1957-1 C.B. 569 (the "Revenue Ruling") also suggests Internal Revenue Service familiarity with dual payor situations. Factually, the Revenue Ruling was concerned with a cooperative agreement between a federal agency and a state for the investigation of the water resources of the state.

Under the terms of the agreement, each party paid a certain amount of the expenses of the project. The agreement also provided that tne field and office work pertaining to the investigation was to be under the direction of the federal agency. The state, however, agreed to carry the individuals on its payroll and to make payment to them for their services.

The individuals involved in the project, worked for, took orders from and were under the control and direction of the federal agency. The state payroll claim, however, was made up by the federal agency and approved by an officer of the state. Moreover, the state did not select, or have any voice in the selection of, the individuals performing the services. For FICA purposes, the Revenue Ruling held that, based upon the applicable common law rules for determining an employer-employee relationship, the individuals were employees of the federal agency.

SUMMARY:

As a result of effecting their respective contractually obligated teaching or research activities concomitant with patient care activities, or both, members of the respective faculties of the Colleges generate Fees. The Fees belong to and are deposited into the practice plan created by a particular faculty member's respective College. From time to time, a particular practice plan pays a substantial portion of the Fees to the University Fund, a statutorily authorized bank account outside of the State Treasury.

For services rendered in his/her role as a teacher and in the health care services provided as incident to those teaching responsibilities, each faculty member is compensated pursuant to a single contract of employment. Generally, payment of such compensation is effected in the form of two documents: a warrant from the State Treasury and a check from the University Fund.

An obvious solution to the "double FICA" situation -- i.e., all payments to be effected solely through the Comptroller -- was not available, because no mutual satisfactory agreement could be reached with the Comptroller. His office's concerns revolved around questions such as (i) when, if at all, would the money transferred to the Comptroller by each of the agency funds, become "state funds" and (ii) what would be the legal ramifications of such monies becoming state funds, such as requiring unacceptable levels of actuarial adjustments in Florida State Retirement System contributions. For their part, the respective agency funds were concerned about (i) non-academic intrusion into the academic decision making process and (ii) loss of flexibility in connection with fixing faculty compensation.

The State and the University Fund each possesses a taxpayer identification number. Each withholds the maximum FICA on the compensation paid by it; albeit, neither deems the University Fund either an employer for purposes of FICA or an entity required to withhold and pay over FICA taxes. Rather, given the existence of separate taxpayer identification numbers, the dual paying over and withholding was utilized solely to insure the Treasury Department that each faculty member's total compensation had been properly recognized for FICA purposes.

The Employment Tax Regulations list a number of factors to be looked to in determining whether an "employer-employee" relationship exists. Treas. Regs. §31.3401(c)-1(b). None are present in the instant situation. Manifestly, there is but one employer -- the State of Florida.

The concept of multiple sources of payment and one employer is not unique. See Regulation Section 404.1256, Code section 3121(u)(2)(D), Senate Bill Report for Section 125(a) of Public Law 98-21, April 20, 1983, PLR 6609164800A, and Rev. Rul. 57-22, 1957-1 C.B. 569. There being one employer, the University Fund should be exempted from FICA responsibility to the extent the State has carried out such responsibility.

Chairman RANGEL. Mr. Rosenkranz, where is the negotiation now? Are you still working this out with IRS?

Mr. ROSENKRANZ. We have a claim for refund at the IRS. It is being considered by the IRS at the agent level.

Chairman RANGEL. Are you still talking with them or is the opinion just pending?

Mr. ROSENKRANZ. My 30 years of practice tell me the opinion is just pending. We can't break—frankly, Mr. Chairman, I can't break through the agent and get to the district counsel's office to speak lawyer-to-lawyer, and so I have every reason to believe that what we are going to get is a denial of a claim for refund and we will have to follow the judicial path.

Chairman RANGEL. Congressman Ben Cardin, a hard-working member of this committee, wanted badly to be here to introduce Mr. Wright, as well as Mr. Lazarus, and he asked me through staff to extend his deepest apologies, as well as indicating that he will be leaving some questions for Mr. Wright for a response in the record.

Now, as I understand it, Mr. Holmes, you are looking for an exemption based on the status of your organization that would relieve you of paying taxes for the employees?

Mr. HOLMES. We represent 3,000 evangelical Christian schools. There are approximately 10,000 private religious schools in America and about 20 percent of them, Jewish, Catholic, and Protestant are not exempt from Federal unemployment tax. Eighty percent of the schools that are members of our association are owned by a church or they are affiliated with a church.

Chairman RANGEL. I understood that in your testimony. Naturally, you know, we try to protect employees in case of job losses and unemployment, and what you are saying is that some entities don't have to provide that protection, and you would like that same type of exemption from taking care of the employees in case of job loss?

Mr. HOLMES. Well, I am aware of religious schools, church schools that choose to cooperate and be part of mandatory—they are—if you are in a church situation. It is not mandatory, but you may participate. If you are an independent board, then it is mandatory. We would like to give the schools the option to choose which way they elect to do, just as church schools do.

In other words, they would not have to participate should they not want to or they could if they chose to.

Chairman RANGEL. I assume that you are hired to make certain it is not mandatory and that the employee, you know, would not be receiving unemployment benefits. I mean, you don't have anything to say about the merits of participating? I know no one likes anything to be done mandatorily, but since it is such a spiritual and religious institution, you know, taking care of employees that are out of work——

Mr. HOLMES. We have asked our schools to very carefully look to ways that they can provide for the needs of their teachers and staff, and each one of them does it a different way, but we have——

Chairman RANGEL. What ways do you do that? What are those ways that you take care of your employees?

Mr. HOLMES. We do not control what the schools choose to do, but we have encouraged them to provide benefits. As a matter of fact, we do annual surveys of what benefits are provided to encourage them to have more benefits, including retirement and ways of providing for the needs for their family.

Chairman RANGEL. But you don't know of any method that they—they haven't told you how they would like to do that, though?

Mr. HOLMES. Well, having served as a superintendent of schools in California, where there was a situation of having attached to FUTA health care benefits in case a person was hurt off the job, we provided that through a private agency.

Chairman RANGEL. Why do you think the religious institutions are exempt from mandatory coverage?

Mr. HOLMES. Congress chose to exempt churches and church-affiliated entities from this law, and we feel that——

Chairman RANGEL. Why?

Mr. HOLMES. Because they are a religious institution and this is a form of taxation.

Chairman RANGEL. It is a form of protecting the employees, isn't it? I don't see any more reason why there should be any exemptions, personally, and so if you protect the employees just because your boss is spiritual, that doesn't mean that the employee should not be protected, in my opinion. In any event, there is no moral basis for it. You just believe that in a sense similar type institutions get the exemption from mandatory coverage for employees, that just because your structure is different and you also are spiritually motivated to take care of the helpless, that you, too, should not have to do it mandatorily, but from the deep spirit in which you feel when you want to do it. OK.

Mr. HOLMES. Yes, sir.

Chairman RANGEL. Mr. Wright, you, I gather, as relates to depreciation and the alternative minimum tax, believe that you are better off under the new law, but not—the past legislation, but it is not as liberal as you would like to see it.

Mr. WRIGHT. The new law deals with basically simplification issues, which are very significant and very useful, but it does not address the issues concerning what we think was an incorrect change included in the 1986 law concerning the lengthening of the depreciation period for automobiles and light trucks. Based upon the 1991 Treasury Department study mandated by Congress, the depreciation period for automobiles and light trucks is much longer than it should be.

Chairman RANGEL. The bakers' problem is one of the distributors being considered as employees?

Mr. FANELLI. Mr. Chairman, if I may take that question, the bakers in the baking industry and the distributors in the baking industry are not looking for classification as independent contractors. We have no reason to claim special treatment in that area, and we think whether or not these individuals are independent contractors or employees should be judged by the same 20-step test that the IRS and the courts have imposed on everybody in the industry.

The problem here is a statute adopted in 1950 which said essentially that even if you were an independent businessman for purposes of FICA tax, you would be treated as a statutory employee under certain limited circumstances. At the time that law was passed, the difference between FICA and SECA rates was significant. The intent of Congress to make sure that bakery drivers had the benefit of the higher FICA contribution rate and therefore higher benefit payment at their retirement was primarily the motivation for the statute. That is no longer the case. The rates are substantially identical for both FICA and SECA, so there is no positive benefit to this statute anymore, and it significantly threatens the ability of the industry to establish independent contractor relationships, which have worked very effectively and efficiently in this industry, to create the kind of success stories that Mr. Cox related to the committee this morning.

Chairman RANGEL. Is there any controversy as relates to the unions involved in the relief that you are seeking?

Mr. FANELLI. I am not aware of any, Mr. Chairman. The industry has functioned substantially identically to the way it functions today since 1950, and this issue becomes important today only because the IRS has recently changed its interpretation of the statute and taken the position that the money that these people invest in purchasing these distributorships, which can be very substantial amounts of money, does not constitute an investment in facilities under the statute.

Early in the 1950s they took the position that it did constitute an investment, and they continued to take that position on an unbroken basis for 40 years, and it is only in the last 2 years that they have reversed themselves on that.

Chairman RANGEL. Mr. Lazarus, did you include in your testimony what benefits institutions such as yours intend to receive from charitable donations if the legislation is changed?

Mr. LAZARUS. The major benefit would be primarily electronic, computer-related equipment that could be used by faculties of our institutions in developing research on the applications of design. This is now not being supported through contributions of equipment because of the way the Tax Code is written.

Chairman RANGEL. And what type of art and design would that be?

Mr. LAZARUS. It is related primarily to the design field, and those would include all applied design from industrial design, automotive design, fashion design, textile design to the graphic arts, and packaging design as well.

Chairman RANGEL. Is there a group of educators in this field that support this? This is not just your institute.

Mr. LAZARUS. No, I am here representing the Association of Independent Colleges of Art, which includes all of the independent colleges. Most of the comprehensive universities in this country have been able to receive this equipment because they offer degrees in the biological and physical sciences. Because we are independent colleges, we are excluded from those gifts because we don't have those degree programs.

Chairman RANGEL. But the independent colleges, they are formal associations?

Mr. LAZARUS. Yes.

Chairman RANGEL. Mr. Hancock.

Mr. HANCOCK. Thank you, Mr. Chairman.

Mr. Wright.

Mr. WRIGHT. Yes, sir.

Mr. HANCOCK. OK. I have two or three questions that I would like to ask you. I think what we are talking about is decreasing the length of time required for depreciation of leased vehicles, primary vehicles. What do you estimate the life to be for a vehicle used in business? What would be the proper number?

Mr. WRIGHT. In our fleet, which I think is representative of the industry and business-use fleets generally, it is between 27 and 29 months. You need to keep in mind that vehicles in that category are generally averaging in excess of 2,000 miles per month, so that level of use is a major factor of the length of the vehicle's term.

Mr. HANCOCK. The lease cars that they are using now on the daily rentals, the companies don't keep them in service for anything close to that length of time?

Mr. WRIGHT. No, sir.

Mr. HANCOCK. If, in fact, we did reduce the time for depreciation, do you have an estimate of how this could affect the economy?

Mr. WRIGHT. Well, I think it is important to recognize, as I said in my testimony, that well over 95 percent of our industry is buying vehicles manufactured by domestic manufacturers. In PHH's case the average is about 97 percent. The ripple effect of the automobile industry in glass and steel and plastic and the rubber industry would have a dramatic stimulus, I believe, to the economy, particularly at this point in time when the automotive industry seems to be coming out of the doldrums. It is not the time to be sending a message on reducing tax benefits on these business-use assets.

Mr. HANCOCK. Well, if we were going to make the depreciation deductions equal the loss of the value of the car, what would the tax law have to say? Would it be straight line depreciation? I think we are using straight line depreciation in my company.

Mr. WRIGHT. Obviously, you can come up with numbers using a combination of changing both the depreciation period as well as the methodology of declining balance. The Treasury, when they developed their study which concluded that 2.8 years was the correct number for business fleet vehicles, that was based upon a straight line determination, but, again, that rate of depreciation—straight line—and depreciable life of 2.8 years is only equal to economic depreciation without any incentive at all. We think that 4 years at 150 percent or 5 years at a 200 percent declining balance also would reach economic depreciation. Again, these combinations of rates and lines do not produce any tax incentive, as other assets have, but would basically reach only economic depreciation.

Mr. HANCOCK. Well, isn't there a cap on vehicles now, the maximum amount that you can depreciate on a business car?

Mr. WRIGHT. It is, for the so-called luxury cars, the types of vehicles that we are talking about in the business fleets generally range from $12,000 to $15,000 and are below that maximum cap.

Mr. HANCOCK. Thank you.

Chairman RANGEL. Mr. Cardin has arrived, but before I recognize him, are there any other members who are seeking recognition?

Mr. Shaw.

Mr. SHAW. Thank you, Mr. Chairman. I will be very brief. I appreciate being allowed to sit with this subcommittee of the committee that we all belong to, the Ways and Means Committee, and I am here because of Mr. Rosenkranz' testimony and what he has put forth for the University of Florida. I very much side with his testimony as to what needs to be done. I think it is very clear here, and, Mr. Chairman, I think you voiced a sensitivity to his testimony. What they are seeking is more of a technical change or a technical correction, I should say, rather than a substantive change in the code.

When we get into a situation, as we are today, where we are trying to bring the cost of health care down, admittedly, this is a very small speck on the total question of health care. However, it is a substantial amount of money to the State university system, which I think should certainly be recouped by them. I would hope that this would be put into law, if Mr. Rosenkranz is not successful with bringing the Internal Revenue Service around without the necessity of legislation. I think that this should certainly appear as a substantive change to the law should the IRS not side with or not fully understand the point that he is making.

It is clearly double-dipping. It is clearly taxpayers' money from the residents of the State of Florida that is being double taxed on the same employee, and I think that the merits are clearly on his side and the side of the university system of the State of Florida. I would just like to add my comments to the record in that regard.

Thank you, Mr. Chairman.

Chairman RANGEL. Thank you, Mr. Shaw.

Mr. Kopetski passes, and the Chair recognizes the distinguished Representative from Baltimore, Md.

Mr. CARDIN. Thank you, Mr. Chairman. I want to thank you for including on this panel two representatives from Maryland, Mr. Wright, who is from PHH, who has done yeoman's service in our community. I just really want to thank him for appearing here today and welcome him to the Ways and Means Committee.

He brings an issue to our committee which I think is extremely important, and that is to try to bring a little bit more economic reality to the depreciation schedules used on leased vehicles. I hope that we will be able to look into this matter and to try to adjust the tax treatment to the realities of the real world as to the useful life of the automobiles involved.

Also, I would like to welcome Fred Lazarus to the Ways and Means Committee. Fred has brought to our attention a matter that is extremely important to many of the private institutions. Fred has done a great service to our community at the Maryland Institute College of Art, and it is a pleasure to have him here.

I would like to ask a question, if I might, to Mr. Lazarus as to the Treasury's view on the legislation that is pending. Treasury has basically indicated that they are not sure that this legislation is needed, because private gifts to your types of institutions have been keeping pace with need. I am wondering whether you could comment as to whether the private gifts have kept pace with the needs of your colleges as the Treasury release would have this committee believe.

Mr. LAZARUS. I can speak both personally and on behalf of others. I have had corporations that are in the business of developing equipment in the fields of design, particularly computer equipment, that have indicated to me that they would not provide that equipment to my institution because we do not qualify under this section of the bill, and have proceeded to support university programs that have biological and physical science programs with these gifts. So there is no question that I and other institutions have been personally experiencing the fact that we do not receive gifts that would make a tremendous difference to us.

There is no question that some of the large universities have been able to secure these gifts because they do have the qualifications of providing degrees in the biological and physical sciences.

Mr. CARDIN. So a company can make a gift to one college but not to another because of the quirk in the current structure?

Mr. LAZARUS. In your district, in the Baltimore area, an institution like the University of Maryland, Baltimore County can receive a gift, and we cannot. That is correct.

Mr. CARDIN. I certainly want UMBC to receive a gift, but would also like to see you qualified to receive a gift. Thank you, Mr. Chairman.

Chairman RANGEL. On behalf of the full committee, I thank this panel for the changes in laws recommended. Staff may be getting in touch with you if there are any other questions that members have and they have not had a chance to ask. Thank you very much.

The next panel, representing the Screen Actors Guild, the American Federation of Television & Radio Artists, and the Actors' Equity Association, is a person well known in the arts from the city of New York, Ron Silver. Also on this panel we have Mark J. Weinstein, counsel from Squadron, Ellenoff, Plesent, Sheinfeld and Sorkin from New York.

We also will be listening to Lawrence O'Toole, president and CEO of Braintree, Mass., representing the New England Education Loan Marketing Corp. and the Education Finance Council. Representing R.R. Donnelly & Sons Co. from Chicago, Frank Uvena, senior vice president. Representing the American Financial Services Association, Richard Romeo, chairman of the tax committee. That concludes this panel.

Mr. Silver, it is good to see you once again. We all admire the excellent performances that you give and those of us from New York are proud to have you be included in our number. The committee is anxious to hear your thoughts on the tax provision as to deductibility for unreimbursed business expenses.

STATEMENT OF RON SILVER, PRESIDENT, ACTORS' EQUITY ASSOCIATION; ALSO ON BEHALF OF SCREEN ACTORS GUILD, AND AMERICAN FEDERATION OF TELEVISION & RADIO ARTISTS; ACCOMPANIED BY MARK J. WEINSTEIN, COUNSEL

Mr. SILVER. Thank you very much, Mr. Chairman. Before I begin I would like to introduce counsel here, Mark Weinstein.

Mr. WEINSTEIN. Good morning, Mr. Chairman, members of the committee. Thank you for allowing me to speak today. I am Mark Weinstein. I am a partner in Squadron, Ellenoff, Plesent, Sheinfeld and Sorkin.

We are tax counsel to several performing artists unions, which include the Screen Actors Guild, the American Federation of Television & Radio Artists, Actors' Equity Association, and the Writers Guild. As you know, seated to my left is Mr. Silver, a distinguished performer who is currently the president of Actors' Equity Association. Mr. Silver will speak on behalf of the performing artists unions in support of a proposal to increase the adjusted gross income ceiling of section 62(a)(2) of the Internal Revenue Code from $16,000 to $32,000.

We encourage Congress to further promote a policy of tax fairness to the lesser known struggling actors, musicians, and writers. These persons were the intended beneficiaries of legislation that was enacted in 1986. In a nutshell, Mr. Chairman, the 1986 tax provision, although enacted with good intention, simply does not work. We are asking you to correct this result.

Mr. Silver.

Mr. SILVER. Thank you. Mr. Chairman, my children went back to school today. It was their first day in school. You are back at work. I am going back to New York after this testimony. I wish us all well this year.

On a personal note to you, sir, being a distinguished alumnus of DeWitt Clinton High School, I will have you know that I went to Stuyvesant High School and for the last 46 years you have defeated us in football. We have never been victorious over you, so I trust that you will show us some kindness today in our presentation.

Chairman RANGEL. You have always exceeded in the arts and sciences, so I yield to you in that field.

Mr. SILVER. Thank you, sir. I don't have to tell you, you know it better than I do, that when legislation is enacted sometimes the original legislative intent might not be effected and revisiting the original legislation and amending it might be required to achieve the bill's original intentions. Justice Scalia notwithstanding, I believe you still believe that.

I am not here on behalf of Steven Spielberg or Madonna, Arnold Schwarzenegger, Sylvester Stallone, Jack Nicholson, et cetera. Congress has already provided all the protection successful people in my business already need. They can form personal service corporations and they can incorporate themselves and deduct all their business expenses above the line.

I am here on behalf of the vast majority of the members of the Actors' Equity Association, the Screen Actors Guild, and the American Federation of Television & Radio Artists, the vast majority who are not able to deduct their legitimate business expenses. And while we asked for this change in 1986, we are partially at fault for not understanding some of the consequences, and it has had a devastating impact, not only on the struggling actors and musicians and performing artists, but on the mid-level professionals.

People outside of our business tend to see it as black and white. There are young kids struggling to get into the business, and then there are very successful people who work in movies and on stage and in TV. The reality of our business is that most people are mid-level professionals that are eking out a living or earning a basic subsistence, married and with children, and it is those people who I am speaking on behalf.

The current law, section 62(a)(2), which amended the code in 1986, was part of that Tax Reform Act. The reason for the change then was to allow the lesser known struggling performers and musicians to deduct their job search and other business expenses such as agent and other representational fees, which generally run 10 percent or more and costs for a video or audiotapes.

Now, the law actually stipulated that a qualified performing artist was permitted to deduct their allowable section 162 expenses above the line. To qualify for a QPA, a qualified performing artist, you had to meet three criteria. You had to have more than one employer in the performing arts, you had to incur allowable section 162 expenses as an employee in connection with such services in the performing arts at an amount exceeding 10 percent of gross income from those services, and you did not have an adjusted gross income as determined before deducting the expenses in excess of $16,000.

Now, what was wrong with this was the law did not provide the relief to the intended beneficiaries; that is, the lesser known struggling artists and the mid-level professionals. The facts are these: Based on 1992 earnings, less than 5 percent of performing artists fell under the $16,000 adjusted gross ceiling.

Now, that sounds pretty good. That means 95 percent of them earned more than that, so what am I here complaining about and asking you here to do? Unfortunately about 92 percent of performing artists earn less than $15,000 from their craft. Now, in order to earn a living wage, most of the people I know in this business have to supplement their income by doing something else. They are waiters, they are lawyers, they are carpenters, they are doing work that will allow them to pursue their craft while also enabling them to earn a living wage to support themselves and their families.

Also in 1987 unemployment insurance became taxable, so if you earned $15,000 and collected $2,000 UIB that would knock you out of the box and put you over the limit as well. What I have here, and I would like to submit for the record in addition to the written record, are two tax forms. One is computed under the 1985 rules and one is computed under the current rules, and if you assume that the taxpayer is a performer working in a regional theater, housing is usually provided for them, but other expenses, including meals are paid out of the performer's take-home pay.

If the performer's weekly salary is $425, which is a minimum in a regional theater, and she is employed for 40 weeks, she has earned $17,000. If the performer spends $15 a day on food, which is not terribly generous and all the other expenses for laundry, whatever, total $50—that is about a $4,250 deduction. If she has received $2,000 in unemployment compensation, under the reform act intended to benefit these people, the performer would have had a Federal tax liability of $1,234. She was entitled to deduct all her travel expenses, even though she didn't file a schedule A at that point. She was also entitled to the standard deduction.

Now, under the current postreform rules, the performer's tax liability is $1,969, a difference of $735 or a percentage increase of over 59 percent. This did not have the consequences that we anticipated. Now, why change the law to accomplish what was originally intended? Performing artists as employees continue to incur costs associated with employment that strongly resemble costs that are incurred by independent contractors, not employees, and I can give you a pretty good example of this from my own career and when I started out.

If I earned $1,000, I had to pay $100, 10 percent commission, to an agent. You have no choice. Every actor, every performer has an agent in the business. They are essentially an employment agency. Now, most employers pick up the employment agency fee. Actors who are currently looking for work over and over and over again consistently pay this employment fee of 10 percent. In order to continue working as an actor where I earned $1,000, I had to get photographs of myself, I had to get audiotapes, videotapes, I had to—in addition to obvious expenses of keeping myself fit and this and that, but that is really secondary. There were necessary expenses that exceeded 30, 40 percent of my income.

Now, why we are asking for some correction of that 1986 bill is that absent a change, the tax burden is not allocated equally to persons of the same dollar gross income. If you are a ditchdigger and you earn $16,000 and most of your expenses are paid by your employer, you have an aftertax cash income of $14,481. Whereas a performing artist earning that same $16,000 and incurring typical employee expenses of 20, 25 percent of earnings or $4,000 has an aftertax income of $10,000.

In 1986 there was an interesting colloquy on the floor of the Senate when then Senator Wilson spoke very eloquently for the unique situation of artists and why they should be treated perhaps specially in this area, and he stated, and I am not quoting him verbatim now, but I am paraphrasing him, that levying a tax on income, not on gross receipts is a concept recognized in the tax treatments of businesses, corporate or not, by allowing deductions for ordinary and necessary expenses that help generate income.

If an employer covered such expenses, they would be deductible to the employer for income tax purposes. The denial of deductions for expenses that truly serve to generate income is not simply bad tax policy, it is not fair: Deductions are not a loophole. Deductibility of legitimate employee expenses ensures that our Federal income tax does not become a gross receipts tax. So respectfully, our proposal would be that if you could see your way clear to increase the earnings ceiling to $36,000, indexed for inflation, only income earned from the performing artist craft be counted in the earning ceiling and the earning ceiling should be tested individually for married taxpayers. If two people are married and they are both actors or musicians or performing artists of any kind, we really need an individually tested ceiling for both.

I would be happy to answer any questions. I don't want to take more of the committee's time.

[The prepared statement and attachments follow:]

August 31, 1993

MEMORANDUM

PROPOSAL ON BEHALF OF PERFORMING ARTISTS FOR U.S. TAX LEGISLATION

Films, television and radio shows, theatrical performances, musical concerts and videos are among the nation's most valuable trade assets. The works created by United States filmmakers, performers, musicians and technicians are dominant in virtually every market on every continent around the world.

American films, shows and concerts are the best in the world because of the expertise that resides in America. These fine artists are hardworking persons who, unfortunately, currently bear a disproportionately greater tax burden than workers in other crafts. Current United States tax policy inappropriately penalizes the performing artist who, of necessity, must contend with irregular employment patterns. The criteria of equity and fairness in the implementation of a tax structure "demands that the income-tax burden should as far as possible apply equally to persons of the same dollar income."[1]

Performing artists[2] contribute to one of the nation's largest export commodities - entertainment; an industry that returns to this country some $4 billion in surplus balance of trade. Most other industries do not yield such favorable trade balances and do not contribute as much to the Gross Domestic Product; yet employees in these industries do not suffer the tax burdens borne by the performing artist under the Internal Revenue Code.

ACCORDINGLY, THE SCREEN ACTORS GUILD ("SAG"), THE AMERICAN FEDERATION OF TELEVISION & RADIO ARTISTS ("AFTRA") AND ACTORS' EQUITY ASSOCIATION ("AEA"), FOR THEMSELVES AND ON BEHALF OF OTHER UNIONS REPRESENTING PERFORMING ARTISTS, RESPECTFULLY REQUEST THAT CONGRESS ENACT LEGISLATION TO EXPAND THE APPLICATION OF INTERNAL REVENUE CODE SECTION 62(a)(2) TO MAINTAIN PARITY IN TAX TREATMENT BETWEEN PERFORMING ARTISTS AND OTHER EMPLOYEES.

CURRENT LAW

The Tax Reform Act of 1986 (Public Law 99-514) amended the Internal Revenue Code (the "Code") to provide an actor or other individual who performs service in the performing arts (a "performing artist") an above-the-line deduction for his or her employee business expenses (allowable under section 162 of the Code) during a year if the performing artist for that year (1) had more than one employer (excluding any nominal employer) in the performing arts, (2) incurred allowable Section 162 expenses as an employee in connection with such services in the performing arts in an amount exceeding 10 percent of the individual's gross income from such services, and (3) did not have adjusted gross income, as determined before deducting such expenses, exceeding $16,000.

In the six plus years this amendment has been effective, the statute has not, in practice, accomplished its objective of providing performing artists parity of tax treatment with that accorded to other laborers.[3]

The $16,000 adjusted gross income ceiling of Section 62(b) has virtually eliminated the intended tax benefit. Based on 1992 earnings and tax information for SAG, AFTRA and AEA members, less than 5% of performing artists fell under the adjusted gross income ceiling. More than 95% of the performing artists had adjusted gross incomes in excess of the $16,000 ceiling, yet their earnings from the performing arts was far below the ceiling.[4] Thus, in order to earn a living wage performing artists must supplement their performing arts income with outside earnings. The $16,000 income ceiling penalizes the performing artist whose earnings from all sources puts him or her above the ceiling. This is an inappropriate result and demonstrates the need for an amendment to Section 62(a)(2).

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[1] Surrey, *The Congress and the Tax Lobbyist - How Special Tax Provisions Get Enacted*, 70 Harv.L.Rev 1145 (1957).

[2] This term includes both persons "in front of" and "behind" the camera.

[3] See the colloquy among former Senator Wilson and Senators Packwood and Bradley, attached hereto as Exhibit A, for a discussion of the reasons for the amendment.

BACKGROUND

The performing artist, while generally treated as an employee under the income tax law, incurs costs associated with his or her employment that strongly resemble costs typically incurred by an independent contractor. This situation arises because of the inherently short-term nature of any particular employment opportunity. While the average American worker will stay at one job for several or more years, a performing artist's term of employment at any particular job will rarely exceed a month or even a day. Due to the short-term nature of his or her employment, the performing artist incurs job search expenses of a type, frequency and amount that are not generally incurred by workers in other industries. For example, an actor will incur expenses for travel to and from various audition sites, resumes, video or audio tapes, photographic portfolios, and gratuities to theater doormen.

Perhaps the most significant and unique costs incurred by a performing artist are agent and other representational fees, which usually are 10% or more of the artist's gross income. No other class of employee is burdened with such a fee. In other industries the employer pays any employment agency fee and gets the benefit of a tax deduction without limitation.

Additionally, performing artists incur other out-of-pocket expenses that further reduce their true employment income. These include costs of photographs, musical instruments, costumes, publicists and practice facilities, as well as costs for maintaining physical condition and personal appearance. It is the rare instance in other lines of employment that such expenses directly effect a person's employment opportunities and success.

PROPOSAL

To fairly allocate the income tax burden to performing artists, we respectfully request that Congress adopt the following proposal:

The language of Section 62(b)(1)(C) of the Code be amended to read in its entirety as follows:

> the adjusted gross income earned by such individual in the performing arts for the taxable year (determined without regard to subsection (a)(2)(B)) does not exceed $36,000[5] (increased by an amount equal to $36,000, multiplied by the cost-of-living adjustment determined under Section 1(f)(3) for the calendar year in which the taxable year begins (but substituting "calendar year 1992" for "calendar year 1989" in subparagraph (B) thereof));"

Such amendment would properly reflect the intent of the 1986 changes by establishing a clearer relationship between the earnings of a performing artist in the performing arts and the tax burden that should be levied on such earnings. A performing artist should not suffer a tax penalty because he or she must supplement his or her income with income from odd jobs and unemployment insurance benefits in order to support self and family. Earnings from outside the performing arts bear no relationship to the performing artist's expenses incurred in the performing arts. Such outside earnings should not restrict a performing artist's ability to deduct allowable business expenses.

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[4] This information was obtained from the 1992 federal income tax returns of a representative sample of performing artists and from earnings reports maintained by SAG, AFTRA and AEA. Attached hereto as Exhibits B through D are charts which show an analysis of 1992 earnings by performing artists.

[5] This amounts represents the median earnings of families in the United States for 1992 as provided by the Bureau of Labor Statistics.

The proposed amendment establishes a ceiling amount which would provide a living wage from the performing arts for the "lesser known, struggling actors and musicians,"[6] which was the intention of the 1986 legislation. Such a ceiling would not benefit any of the "better known" performing artists.

CONCLUSION

The proposal set forth herein should be adopted in order to provide equity and fairness to performing artists who necessarily incur business expenses of a type, frequency and amount not incurred by other employees. Otherwise the performing artist will continue to bear a higher income tax burden on his or her true economic income.

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[6] 132 Cong. Rec. S 8132 (June 23, 1986). See Exhibit A for the complete text of former Senator Wilson's statement.

EXHIBIT A

132 Cong Rec 5 8132 Monday, June 23, 1986

The PRESIDING OFFICER. The pending business is the committee substitute.

Mr. WILSON addressed the Chair.

The PRESIDING OFFICER. The Senator from California has the floor.

AMENDMENT NO. 2157

(Purpose: To allow for deduction of certain expenses related to an individual's trade or business)

Mr. WILSON. Mr. President, as the votes on the Senate floor have made clear, there is broad support for the tax reform bill as it was reported by the Finance Committee. It is a bill that I enthusiastically support, and it is a bill that I hope to see enacted -- enacted in a form very close to that of the bill now before us.

But one issue I believe is dealt with better in the House bill is the treatment of miscellaneous business expenses.

Mr. President, while there are many commendable reforms to be undertaken as part of tax reform, we must remember that we are levying a tax on income, not gross receipts.

This concept is well recognized by the tax treatment of businesses, be they in corporate form or not, by allowing deductions for ordinary and necessary expenses that help generate income. A broad array of deductions are allowed, from advertising expenses, association dues, and costs of equipment to hand tools and typewriter ribbons.

Yet, deductions for these same expenses would be denied by the Senate's tax bill. No longer would carpenters be able to deduct the cost of tools or a police officer deduct the cost of uniforms. Furthermore, if an individual loses his or her job and incurs significant expenses to find a new one, none of these expenses would be deductible. I find this last change particularly objectionable when considering all of the money we spend through direct Federal payment for unemployment coverage or trade adjustment assistance in order to help the unemployed.

It should also be noted that if an employer covered such expenses, they would be deductible by the employer for income tax purposes -- and they would not be imputed as income to the employees.

Mr. President, denial of deductions for expenses that truly serve to generate income is not simply bad tax policy, it is not fair.

In this regard, I believe that the House took the proper route by allowing for the continued deductibility of these employee expenses, while imposing a 1-percent floor. The 1-percent floor is a reasonable threshold that allows us to lower rates while imposing a relatively small burden on individual taxpayers. Furthermore, it removes a significant auditing problem for minor expenses that may be only tangentially related to the taxpayer's employment, thereby reducing compliance costs. Unfortunately, the Senate bill, while also imposing a 1-percent floor, eliminates the deductibility of most types of employee expenses. Mr. President, elimination of the employee expense deduction is not supportable as a means of lowering tax rates, for the deduction is not a loophole, nor is it an incentive that furthers some governmental policy that we can no longer afford if we are to have lower tax rates. Rather, deductibility of legitimate employee expenses ensures that our Federal income tax does not become a gross receipts tax.

Mr. President, in order to show the impact that the Senate bill's treatment of employee expenses would have, I want to highlight one type of deduction that will no longer be allowed and its effect on one group of employees performing artists.

The one aspect of the bill that I am referring to is the repeal of the deduction for expenses incurred to search for new employment. This change will place an additional burden on someone looking to change jobs, and will be particularly severe for anyone who is unemployed.

Within the group of unemployed, the change envisioned by the Senate tax bill could have a devastating impact on people in the motion picture, music, and television industries, as well as those who ply their trade on the stage or as models, for by the very nature of their profession, their costs for finding new employment recur over and over again in a continual fashion.

That is why I have prepared an amendment to the tax bill in order to restore the deductibility of agency fees and related expenses that are incurred for the purpose of finding new employment of limited duration.

Mr. President, what makes the impact disproportionately severe on actors, producers, directors, musicians, and others in the entertainment industry is that such individuals are constantly looking for new work, with the assistance of agents and others, no matter how talented they may be. Employment is always temporary, for regardless of how successful a movie or television show you appear on, regardless of how good a musician you are, and regardless of how successful a show you may be acting in, it is highly unusual that the length of employment will extend as long as 1 year. Indeed, the employment more often that not lasts only a few months, a few weeks, or even 1 day.

Now, the bill does not affect all similarly situated people in the same fashion. It hurts only those in the entertainment industry who are at the bottom of the ladder. Those at the top are unaffected by this one particular change.

The reason for the disparate treatment is that the big-name actors, musicians, and others, have most often formed personal service corporations. And, like other corporations, the cost of finding new business is an ordinary and necessary business expense deductible by them. Or such people may perform their work as independent contractors. And like other independent contractors, the cost of acquiring new work is deductible to them as independent contractors.

The lesser known, struggling actors and musicians will, when they can find work, be hired as employees -- and their agent and other representational fees, which run 10 percent or more, will not be deductible. Also nondeductible will be the costs of their resumes, which, because they often include video or audio tapes as well as photographic portfolios, can cost hundreds of dollars.

Unfortunately, this group of lesser knowns constitute the vast majority in the entertainment business. According to the New York Times, of the 50 percent of the members of Actors Equity that work during the year, half earn less than $4,500. And at the Screen Actors Guild, 70 percent earn less than $2,000 per year at their craft. At the American Federation of Television and Radio Artists, the picture is somewhat brighter, but even there the median pay is $11,000.

I do not know what the revenue impact would be of a remedial change to the tax bill that would fix this problem. But I do know that leaving the bill in its present state would unfairly penalize those struggling for success as entertainers, for, by denying them deductions for legitimate job-search costs, the kind that they continually must incur, it would make it even more difficult for them to find employment.

I ask unanimous consent that a copy of this amendment No. 2157 be printed in the Record.

There being no objection, the amendment was ordered to be printed In the Record, as follows:

On page 1413 of the amendment, strike out line 24 and insert in lieu thereof the following:

employer, and

"(4) Expenses for obtaining employment of limited duration. -- The deductions allowed by part VI (sec. 161 and following) which consist of agency fees and other related expenses directly related to the seeking of employment of limited duration in the taxpayer's present trade or business, under regulations to be prescribed by the Secretary."

Mr. WILSON. Mr. President, I have a concern as I have stated and I know that that concern is deeply shared by my colleague, the senior Senator from New Jersey, and I would be pleased to inquire of him at this time his thoughts on this issue.

Mr. BRADLEY. Mr. President, let me commend the distinguished Senator from California for raising what I consider to be a short coming in the Finance Committee bill. Existing law allows employees to deduct ordinary and necessary expenses incurred in performing their jobs.

The Finance Committee bill, recognizing this provision has been abused and has also imposed burdensome recordkeeping requirements, made some changes I believe that went too far. I believe the bill went too far in making draconian changes in this area.

I say to the distinguished Senator from California who I know is extremely sensitive to the area that the amendment relates to, which is the performing arts, that the issue is even broader than he has defined it. It is true that performing artists will be particularly hard hit by disallowances of deductions of employee business expenses but it is not just agency fees, and I think the Senator's statement laid that out.

It is not just agency fees that we are talking about here but legitimate out-of-pocket expenses for things like photographs, musical instruments, costumes, publicists, and so on, that are legitimate expenses incurred in producing income and therefore ought to be deducted.

I would say to the Senator that although performing artists are an important example of this, a very important example of this, as he also correctly pointed out, there are many other professions that would be affected by a draconian provision in the final bill.

Take, for example, trades people like carpenters or bricklayers, or whatever. They have to furnish their own tools and those should be deductible. Expenses of those employees who have to buy their own uniforms in order to get a job ought to be deductible. All these expenditures are legitimate business costs. If they exceed 1 percent of the floor they should be deductible.

Let me say to the distinguished Senator from California that I share his concern and I support what he is trying to do, and I hope that the conference will restore the deduction for all employees.

Mr. WILSON. Mr. President, I thank the Senator from New Jersey for his comment. I know that he has been very much concerned with the same problem, and I know that it is his purpose to work for the elimination of this problem in a way that is fair and equitable and that will allow those employees, who have the myriad of expenses of the wide range that he has described and that I have touched on in my own statement, to find some relief.

I wonder if I might inquire of the chairman of the Finance Committee, whom I know has been eager to keep the bill in its present form and as free of amendments as possible, whether or not his views are compatible with those expressed by the Senator from New Jersey and the Senator from California. I know that he, too, is aware of the problem.

Mr. PACKWOOD. I am. I talked to the Senator from New Jersey, and the Senator from California was good enough to talk to me before he started his comments tonight.

I am sympathetic to the problem. I think it is one that should be addressed on a broader scale than one or two occupations or professions. That is obviously an issue in conference that we will consider.

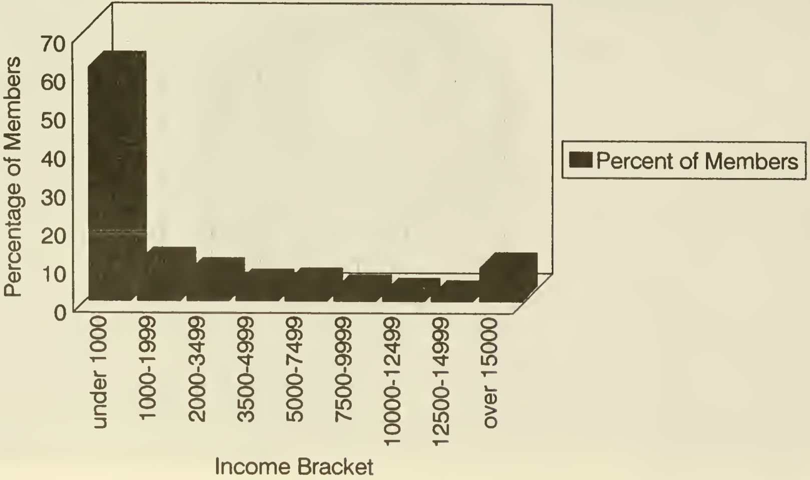
Mr. WILSON. I thank the distinguished chairman of the Finance Committee.

Mr. President, based on the colloquy that we have had, it is not my purpose to pursue the amendment at this time. I am reassured by the expressions here on the floor of a recognition that this problem Is one that needs to be dealt with. I will look forward to the action of the conferees to bring equity to it.

EXHIBIT B

Estimate of Members Earnings

From the Performing Arts - 1992

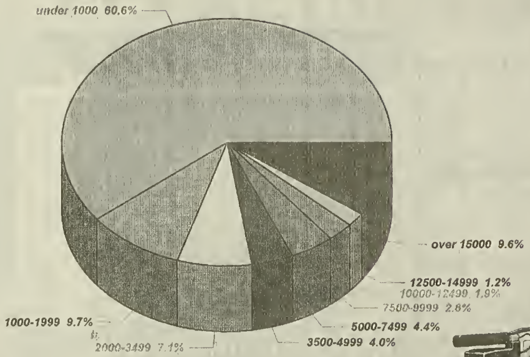


Screen Actors Guild

EXHIBIT C

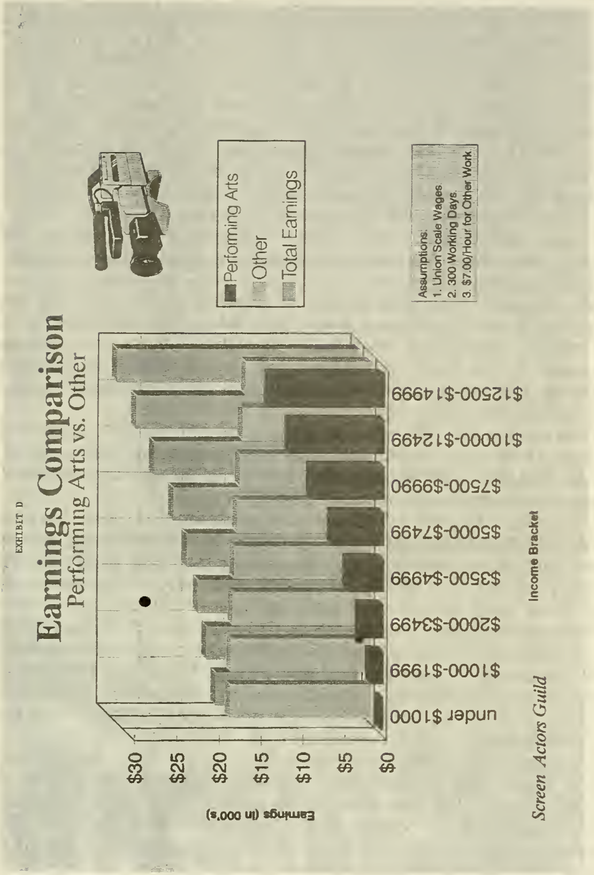
Estimate of Members Earnings

From the Performing Arts - 1992



Screen Actors Guild

EXHIBIT D



Earnings Comparison

Performing Arts vs. Other

Assumptions:
1. Union Scale Wages.
2. 300 Working Days.
3. $7.00/Hour for Other Work.

Screen Actors Guild

Chairman RANGEL. I know you have to leave and you will be excused. We will present whatever questions to you—first of all, you know the committee and the Congress are very supportive of struggling people. We know how difficult it is to break through. It is equally as difficult for us to determine who is serious about being in the business and who is serious about whatever they do.

We are going to have to work to attempt to fine tune this, and if you don't have the answer today you can think about it, because nobody in the business would want someone getting deductions that they don't really deserve merely because they declare themselves as wanting to be considered a performer.

I can understand your audio tapes and your agent fees and things like that. You weren't implying that meals should be deducted in that, were you?

Mr. SILVER. Yes. I was kind of explicit about it in my example. Perhaps I shouldn't have been. But when you are on the road for 40 weeks, you often don't have facilities where you can cook for yourself or do that. We have just got even the provision where housing has been provided. Often not all your travel expenses to get to the job, $15 a day.

Chairman RANGEL. As long as you agree that this has to be shown, that is in connection with working in the arts.

Mr. SILVER. Absolutely. It should be connected to how much money is actually spent.

Chairman RANGEL. You see the problem that can be presented.

Mr. WEINSTEIN. Yes. I have two comments to make, one with respect to your concern about those who are not really in the business. I believe the hobby loss rules currently in the Internal Revenue Code take care of that problem.

Two, with respect to meals and travel, the provision would only govern those expenses that are allowable deductions under section 162, meaning if the artist is away from home for less than a year doing a road show and the expenses are otherwise allowable under section 162, those would be within the coverage of this provision currently and hopefully as extended.

Chairman RANGEL. Besides the items already mentioned, what other deductions do you think would be equitable in this area?

Mr. SILVER. Any expenses incurred to allow them to generate income, pursue their crafts and continually look for new work, because employment in my field is always temporary. When you finish a job, you don't know when the next job is coming, or if there will be one. If somebody is earning $30,000 or $35,000 in their chosen profession, something that they allegedly love to do, it is very unlikely that they will be doing another job to generate more income. If people are lucky enough to earn—$36,000 is the median for a family of four—if they are lucky enough to earn that, very few of them are pursuing other work to supplement their income unless they want to live a certain way which we would not have it be allowable. That is why we are asking for that figure at that point.

Chairman RANGEL. Mr. Hancock.

Mr. HANCOCK. When you say "in the business," can that be measured fairly easily by the amount of income?

Mr. WEINSTEIN. That is correct, sir.

Mr. HANCOCK. If you are really in the business, you will have some income from it. I don't understand what you mean by——

Mr. WEINSTEIN. The hobby loss rules deny deductions for expenses incurred for someone who is not really in the business, but instead is pursuing a hobby. If you are committed to being a performing artist, there is always an opportunity of earning $1,000, $10,000. Given the commitment of time and effort and expenses that the performing artist incurs, that would be good evidence of whether he or she is really in the business.

Mr. HANCOCK. Are you talking about being able to deduct expenses beyond the amount of income from other sources? That is what I don't understand. You can't deduct expenses from nothing, can you?

Mr. WEINSTEIN. If you are not subject to the hobby loss rule, that means all expenses are allowable. If your expenses exceed income and your total income threshold is under $16,000, under current law you would get full benefit for the deductibility of your allowable expenses.

Mr. HANCOCK. Thank you.

Chairman RANGEL. Do other members have questions? Mr. Kopetski.

Mr. KOPETSKI. It is not clear if nonperforming art income is included in that $16,000 ceiling or not.

Mr. WEINSTEIN. The current law does not differentiate between income from the performing arts and income from outside the performing arts.

Mr. KOPETSKI. I assume that new performing artists are not taking advantage by either organizing as a corporation, a personal corporation, because it is just not worth filing the papers and spending the money to become incorporated, is that the case?

Mr. SILVER. I think most business managers would tell you that that only pays to do at a certain income level. People earning so few dollars, it probably doesn't pay for them to do that.

Mr. KOPETSKI. The Tax Code requires that they be employees rather than declare themselves an independent contractor. They would not meet the test of an independent contractor even though they are working a day here, maybe a week there?

Mr. SILVER. One of the mistakes we made is that when we said "had more than one employer," we didn't take into account where somebody works at a theater in Los Angeles or Chicago and are employed for the season, and are lucky to be so employed, and they work for 40 weeks, don't work the other 12 weeks, and they have only had one employer. There were a couple of things that we were remiss in not bringing to your attention in 1986.

Mr. KOPETSKI. The one employer would be stricken from the code—you are going to keep the one employer exemption?

Mr. SILVER. It is three-pronged. To qualify as a performing artist you had to have more than one employer in the performing arts because we assume that is the nature of the business everybody does. But we didn't take into account some people who are employed on a long-term basis only having one employer.

Mr. KOPETSKI. Do you think we should address that by a 26-weeks-of-the-year type? Is that something that is common, in other words, in the theater?

Mr. SILVER. Yes. We have a lot of actors who are employed by one theater for the season and don't find employment for the other 20 weeks they are not working.

Mr. KOPETSKI. Perhaps we should try to address that issue as well, Mr. Chairman.

Oregon has a growing film industry, and also we have a lot of writers living there because of our great quality of life there. I wonder if that is just my impression, or is it true that with airplanes and faxes and modems today that people aren't necessarily living just in New York or California and involved in the performing arts industry, and that there may be different kinds of deductions today if they are a screenwriter or playwrite, et cetera?

Mr. SILVER. That is correct. Most of the people I know, if they had the option, would probably live in Oregon.

Mr. KOPETSKI. New York is a nice place to visit.

Mr. SILVER. I like it.

Mr. KOPETSKI. Thank you, Mr. Chairman.

Chairman RANGEL. You are welcome to stay, but recognizing that you have a pressing schedule in New York we thank you for your testimony.

The committee is anxious to work with you to make certain that where applicable as relates to aspiring artists that at the same time we can distinguish between them and others that are just doing it for a hobby. Thank you very much.

Mr. SILVER. Thank you very much, Mr. Chairman.

Mr. WEINSTEIN. Thank you very much.

Chairman RANGEL. We will next hear from Lawrence O'Toole, president and CEO, representing the New England Education Loan Marketing Corp.

STATEMENT OF LAWRENCE W. O'TOOLE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NEW ENGLAND EDUCATION LOAN MARKETING CORP., AND EDUCATION FINANCE COUNCIL

Mr. O'TOOLE. Thank you for the opportunity to appear before you today in support of H.R. 2603, the bill introduced by Congressman Richard Neal, a member of your subcommittee, and Congressman Joseph Moakley.

My name is Lawrence O'Toole and I am the president and chief executive officer of Nellie Mae. I am before you on behalf of Nellie Mae and on behalf of the Education Finance Council, which is a trade association including 23 States and nonprofit secondary markets involved in the Federal student loan programs, thereby representing virtually all of the nonprofit student loan providers and all of the organizations that might be affected by this bill, if enacted.

As you know, the recently passed Budget Reconciliation Act included the Student Loan Reform Act of 1993, which substantially altered Federal policy in this area and the 28-year-old public-private partnership that has provided student loan capital for generations of students.

Under this legislation, a new direct Federal loan program will be phased in over the next 4 years, increasing to a level of 60 percent of total national student loan volume in 1997–98. Conversely, the current Federal programs are expected to gradually reduce their volume to 40 percent of new loan volume by that time. This gradual and halfway solution represents a compromise between the Clinton administration's desire to convert fully to a direct loan program and those in Congress who were concerned that abandoning the current system without first testing it presented too great a risk to the delivery of funding for college students.

I am before you today to recommend your consideration and approval of Tax Code changes which we believe complement these changes in Federal education policy, but which fall under the jurisdiction of the Ways and Means Committee rather than the Education Committees. In many respects these complementary, hand-in-glove changes mirror the policy actions taken by Congress in 1976 which substantially expanded the guaranteed student loan program to provide access to student loans for all American students and concurrently made Tax Code changes which authorized the creation of scholarship funding corporations, organizations such as our own.

As background, there are 21 scholarship funding corporations, as defined in Tax Code section 150(d), across the country which provide secondary market support and services in the Federal student loan programs. Nellie Mae is the largest of these and the fourth largest student loan holder in the country. All other funding scholarship corporations rank among the 100 largest providers of student loan capital in the Federal programs.

We have been and can continue to be effective stewards of Federal policy, providing innovation and superior administration of these programs. Our local and regional focus and familiarity with students, colleges and lending institutions in our areas contribute to our strong performance. As an example, the Department of Education recently released cohort default rates by a lender, and in those statistics Nellie Mae's default rate was less than half of that of the Student Loan Marketing Association, a Government-sponsored enterprise.

Section 150(d) of the code defines scholarship funding corporations as private nonprofit corporations which are designated by State or local governments and the activities of which are dedicated exclusively to the Federal student loan programs. Since 1976 the code has permitted these private nonprofit organizations to issue tax-exempt debt to fulfill the education policy objectives of the Federal Government.

We believe that the Tax Code changes that we seek in section 2603 will again better permit our organizations to contribute to the attainment of Federal policy objectives by, one, allowing us to increase the level of funding which we can efficiently and effectively provide to students to make up for any reduction or withdrawal of commercial lending institutions during this phase-down period; two, by removing the restriction that our nonprofit activities be exclusively related to the diminishing Federal loan programs, thus allowing us to participate in activities permissible for section 501(c)(3) organizations generally; and three, in the longer term providing an effective transition for these organizations to the tax paying sector of our economy in order to preserve the experience and expertise that has been developed over the past 17 years.

We have been in close communication with the staff of the Joint Committee on Taxation, the staff of the Treasury Department, and, as a result, we believe that amendments to the original 2603 can be developed to effectively meet the transition objectives of our organizations to satisfy the legitimate Federal tax policy questions concerning nonprofit corporations and tax-exempt organizations and can, over time, result in a conversion to the taxable sector which will generate significant Federal tax revenues over a 5-year period.

In brief, the amendments to 2603 would allow the transfer, at fair market value, of a scholarship funding corporation's student loan assets and of its outstanding debt, both taxable and tax-exempt, to a successor taxable corporation.

Further, the scholarship funding corporation would be permitted to invest any of its net assets into the equity stock of a successor taxable corporation, but providing that equity interest was senior and superior to any subsequent or additional equity interest, as issued by the taxable corporation.

The amendments recognize the need for a transition provision in this area providing a limited exception to the so-called "excess business holding" ruling that is applied to tax-exempt private foundations. This exception is limited in both time, 10 years, and scope of business activity requiring that the successor corporation continue to engage to at least 50 percent of its business activities in the Federal student loan programs.

While the amendments allow the transfer of outstanding tax-exempt debt to a taxable corporation, they do not create a new private use as prohibited by the code. The use of tax-exempt debt to support student loans has been part of the code since 1976. Similarly, no changes to the statutory or regulatory treatment of the tax-exempt bonds are proposed nor are there changes suggested that would change the private activity bond caps by State. In this area, consistent with the tradition of transition amendments, both the tax-exempt corporation and the successor taxable corporation would waive or forgo their ability to issue any tax-exempt debt in the future. So we would be talking about just the currently outstanding tax-exempt debt which would itself pay down over the stated maturity of those debts.

In closing, I want to thank Mr. Neal and Mr. Moakley for their sponsorship of 2603 and thank the subcommittee members and staff for their interest. We believe that we have achieved that most elusive of targets, a proposal endorsed by virtually the entire affected population which helps to attain Federal education policy objectives and which contributes to Federal tax revenues.

I would be pleased to answer any questions at the conclusion of the panel.

Mr. KOPETSKI [presiding]. Thank you for your testimony.

[The prepared statement and attachment follow:]

Statement Of

LAWRENCE W. O'TOOLE

President and CEO

THE NEW ENGLAND EDUCATION LOAN MARKETING CORPORATION

On Behalf Of

NELLIE MAE

AND

THE EDUCATION FINANCE COUNCIL

Submitted To

THE SUBCOMMITTEE ON SELECT REVENUE MEASURES

United States House of Representatives

September 15, 1993

I.

Introduction

My name is Lawrence W. O'Toole. I am President and Chief Executive Officer of The New England Education Loan Marketing Corporation, also known as "Nellie Mae". I appreciate this opportunity to follow up my appearance before the Subcommittee on Select Revenue Measures by submitting this statement on behalf of Nellie Mae, and on behalf of the Education Finance Council, whose membership contains sister organizations from across the country.[1]

We hope to serve as constructive participants in the development of federal policy relating to student loan programs. The contours of the federal policy in the student loan area have changed over time to reflect the changing needs of our nation's students. In this connection, we urge the Subcommittee to support tax amendments that would permit scholarship funding corporations to evolve, as the federal student loan programs evolve, so that we can continue to accomplish our mission to support these programs. The amendments contained in H.R. 2603, introduced by Congressmen Neal and Moakley, represent a practical and efficient means of assuring continued private sector support for the programs without market dislocation. We hope the Subcommittee will support an amendment of this type, as we do.

Scholarship funding corporations, which are described in Internal Revenue Code section 150(d), are private, nonprofit corporations which are devoted exclusively to providing capital and services to support student loans made under the Federal Family Education Loan Programs. We serve principally as secondary markets for these loans. Altogether there are approximately 21 nonprofit scholarship funding corporations servicing this nation's students and their educational lenders.

We believe that passage of an amendment reflecting the concept embodied in H.R. 2603 is vital to accomplishing our mission of assuring that college students receive the financial

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1/ Attached as an appendix hereto is a brief description of the membership of the Education Finance Council.

assistance they need. This financial assistance amounts to $15 billion in new student loans each year, which will be funded through the current Federal Family Education Loan Programs and through the recently enacted Federal Direct Loan Program.

II.

The Role of Secondary Markets for Student Loans

A. Secondary Markets within the Framework of the Privately Funded Student Loan Programs.

Since the enactment of the Higher Education Act of 1965, Congress has championed affordable financing for college education. Until the enactment of the Omnibus Budget Reconciliation Act of 1993, which provides for a graduated phase-in of student loans funded by the federal government, the hallmark of our nation's higher education policy has been to encourage private lenders to provide affordable student loans under the federal guaranteed student loan programs. These programs rely on the voluntary participation of private sector organizations to provide capital to originate student loans, to provide secondary markets offering liquidity to lenders and to service these loans.

To further its policy of encouraging low-cost educational financing, Congress has long permitted state and local governments and organizations formed on their behalf to issue tax-exempt bonds to raise capital to acquire or finance student loan notes. However, because some states and local governments were not permitted to form organizations that could issue tax-exempt financing for student loans, under a special provision enacted by Congress in 1976 private, nonprofit corporations formed under state law and whose income is devoted to acquiring student loans are permitted to issue tax-exempt bonds to finance the purchase of those loans.

For this reason, it is fair to say that nonprofit scholarship funding corporations are literally creatures of the federal student loan programs and the tax code. In order for the interest paid on outstanding tax-exempt bonds to remain exempt from federal income tax, we are required to operate exclusively for the purpose of acquiring student loan notes made under the Higher Education Act of 1965. However, because of the many statutory limitations and restrictions on the use of tax-exempt financing, scholarship funding corporations often use both taxable and tax-exempt sources of debt to finance the acquisition of student loan portfolios. As nonprofit corporations, we are prohibited from raising capital to support student loan programs through the equity markets.

Nonprofit scholarship funding corporations serve an important function in the student loan financing process, by assuring a reliable source of replacement capital for originating lenders. By providing liquidity to lenders, the lenders are able to make more loans to student borrowers. The importance of our role is recognized by Congress and the Department of Education, which treat nonprofit scholarship funding corporations as "eligible lenders" under the federal student loan programs.

But our efforts go far beyond merely acquiring and holding student loans. Although our primary purpose has been to serve as a secondary market for originating lenders, in fact we provide a broad array of services to the federal student loan programs and participants in those programs. These include originating student loans themselves, consulting with and advising lenders and loan guarantors regarding underwriting, servicing and default controls, and assisting borrowers with repayment matters. We also have devised sophisticated, financial systems which account for and monitor outstanding loans. Our workforce is experienced, well-trained and efficient.

In sum, scholarship funding corporations have brought much innovation and efficiency to the federal student loan programs. This has reduced the burdens of students, lenders, guarantors and the federal government, while facilitating the delivery of $15 billion in new loans to almost four million students annually. Our local and regional activities often place us closest to the student borrower and make us better able to secure repayment of troubled loans, which reduces federal costs. As a consequence of our local nature and our systems and procedures, we are able to minimize the default rate on the student loans we hold.

The Student Loan Reform Act of 1993, adopted as part of the recently enacted Omnibus Budget Reconciliation Act of 1993, represents a substantial shift in federal policy and will, beginning in as little as 10 months, create a new federal direct student loan program to compete with the current federal student loan programs.

Our foremost concern -- and I am sure the concern of Congress as well -- is that all eligible students have access to the loan capital which they need to complete their educations. Our organizations have played and can continue to play substantial roles in assuring that this goal is accomplished.

For reasons outlined below, there will continue to be a great need for private capital during the four year phase-in period of the direct loan program. The concepts of H.R. 2603 effectively will allow scholarship funding corporations to have access to equity capital that can be leveraged for the benefit of the student loan programs during this period. Just as important, these concepts will provide scholarship funding corporations the opportunity to remain "going concerns" having the flexibility to preserve and best utilize our expertise and operational capabilities to support the new federal policy and the administration of the federal student loan programs after 1997.

B. Anticipated Consequences of Federal Student Loan Program Changes.

Under the recently passed Budget Reconciliation Act, signed into law by President Clinton on August 10, 1993, the federal government will begin making direct student loans in the 1994-95 academic year. Direct loans will account for a maximum of 5 percent of loan volume in that year, increasing to maximums of 40 percent, 50 percent and 60 percent in the 1995-96, 1996-97 and 1997-98 academic years, respectively.[2/] The direct loan program adopted by Congress will rely to a large extent on colleges, universities and other institutions of higher education to originate loans with students. In addition, however, the federal government will contract with third parties for loan origination, servicing and collection activities. Thus, under the direct loan program, significant private sector participation will be required to implement and administer the program. As noted above, these functions are many of the same now successfully performed by nonprofit scholarship funding corporations, and we believe that students will benefit if the federal government has a large pool of competitors for these service contracts.

With the introduction of the direct loan program and the many financial cuts made in the current programs, it is expected that a number of lending institutions will terminate their participation in the federal programs. This will occur for several reasons. First, with the advent of a direct loan program, many lenders will decide to devote their resource to

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[2/] It is not clear at this juncture what changes to the mix of privately and publicly funded student loans will occur after academic year 1997-98.

investments other than the guaranteed student loan programs.[3] Lenders will find it difficult to justify increasing their investment in a program that may be phased out and ultimately eliminated. Moreover, the impetus for lenders to terminate participation during the transition period will increase because of the significant reduction in financial incentives for participation, such as the required one-half percent origination fee charged lenders and required default risk-sharing under the new policy. Second, there will be increased concern among lenders that state guaranty agencies will experience financial difficulty because of the potential impact of reduced loan volumes on the revenues and solvency levels of those guarantors and due to their own risk-sharing. Third, capital markets may be more reluctant to invest in the bonds and notes of nonprofit scholarship funding corporations during the transition period.[4] As a consequence of these scenarios, one can expect that the availability of private sector capital could decline significantly during the comparison period.

In summary, the phase-in of the direct loan program, especially when coupled with reduced financial incentives for private lenders and state guaranty agencies, virtually assures that only focused, high volume lenders will remain to provide private loans to students. The overall loss of private capital to sustain student loans issued by the private sector during the transition period will result in a substantial need for capital from other sources, a need which can be met effectively by scholarship funding corporations aided by the proposed amendments.

C. Impediments Preventing Scholarship Funding Corporations from Raising Needed Capital.

Many nonprofit scholarship funding corporations are ready and willing to meet the additional private sector capital needs during the transition phase. Unfortunately, however, we face both legal and practical constraints affecting our ability to raise additional capital to support the transition. From a legal standpoint, as nonprofit organizations described in section 501(c)(3) of the Internal Revenue Code, we are unable to raise equity capital from private investors. All of our equity capital must be internally generated through retained earnings. Because our earnings-generated equity capital builds slowly, it cannot itself be expected to provide sufficient additional capital to meet funding needs.

The prohibition against equity investment also serves to limit the amount of debt financing which may be accomplished as a result of the insistence of the financial markets on reasonable debt-to-equity ratios. For example, Nellie Mae's own ratio of debt-to-equity is approximately 20:1; thus, increasing debt levels substantially to accommodate large new loan volumes may be difficult.

Further, the default risk-sharing and reduction in loan yield provisions of the Budget Reconciliation Act will make debt financings more difficult without added cushions of equity protection for bond and note holders.

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[3] For example, already one of the nation's largest banks has solicited proposals to sell its student loan portfolio worth approximately $250 million.

[4] As a consequence, to the extent they do in fact invest, investors likely will require higher interest rates to account for this perceived greater risk.

Lastly, potential investors will look to the single purpose restriction of section 150(d) with concern and ask the question, "How will the experience and expertise of these organizations be utilized if up to 60 percent of the student loans made under federal programs are converted to direct federal loans?". The transition relief provided by H.R. 2603 effectively responds to that question by providing long term opportunities to utilize that expertise, while facilitating the delivery of needed private capital during the transition period.

We believe our nation's students will continue to derive substantial benefits by having regional organizations, such as ourselves, compete with Sallie Mae for secondary market purchases of loan portfolios and for services to be provided to the Department of Education with respect to direct student loans. It is virtually impossible to believe that the private sector capital required during the transition phase could be raised by start-up corporations nor used efficiently by such corporations during the transition. The time frame is simply too short and the investment in systems and personnel too great. The solution to the anticipated capital vacuum must address the need to avoid operational redundancies and to preserve operational efficiencies. Nonprofit scholarship funding corporation stand ready to assist in solving the dilemma caused by this anticipated capital drain.

III.

The Efficient Transition Solution of H.R. 2603

The basic concept of H.R. 2603 offers a simple yet efficient blueprint for strengthening the ability of the private sector to provide capital during the transition phase and, at the same time, contributing to an increase in federal tax revenues.

In brief, H.R. 2603 provides three substantive elements of transition relief. The first is the deletion of the restriction that the nonprofit organization electing the transition be engaged exclusively in providing a secondary market for the federal student loan programs. This amendment would allow the nonprofit to engage in activities permitted Internal Revenue Code section 501(c)(3) organizations generally. Although it would retain an economic investment in a corporation taking over its student loan secondary market role, the nonprofit must remain devoted to charitable, educational or other exempt activities.5/

The second element would permit the transfer of the scholarship funding corporation's assets, and the assumption of its outstanding debt (both taxable and tax-exempt), by a successor taxable corporation in exchange for an economic investment in the successor. This element would permit the scholarship funding corporation to make a transitional investment of its net assets in the equity stock of the successor

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5/ Nellie Mae, through its sister organization Nellie Mae, Inc., itself a section 501(c)(3) organization, already undertakes traditional charitable activities. It has established the Nellie Mae Fund for Education which, over the last three years, has provided more than $2 million in funding for over 76 educational projects. These grants have included projects designed to encourage at-risk students to stay in school, establish goals, and build aspirations that provide the impetus to pursue post-secondary education. In addition, Nellie Mae, Inc. engages in programs designed to expand access to higher education financing for students and families no longer eligible for federal programs or whose financial needs exceed the limits of federal student aid.

corporation. The successor would be able to increase its equity capital by the issuance of further equity stock interests, as necessary to provide acceptable ratios for further debt issuance to meet student loan needs. This solution will solidify the secondary market for student loan notes during the transition period, provide additional capital for loan origination, and preserve the student loan origination and servicing expertise that will aid the federal student loan programs after the transition is complete. Most significantly, these goals will be accomplished as efficiently as possible, without the inevitably wasted lag time or market dislocation that would occur if scholarship funding corporations were forced to wind down.

Finally, the third element of relief is the ability to structure the nonprofit's economic investment in the successor to contain voting rights, without causing the immediate imposition of the tax on the "excess business holdings" applicable to certain nonprofits. This relief will afford the nonprofits the ability to protect their investment.

Specifically, H.R. 2603 would amend section 150(d) of the Internal Revenue Code to permit a nonprofit scholarship funding corporation to elect to transfer all of its student loan notes to a for-profit successor corporation, and for the successor corporation to assume (or otherwise arrange to repay) the outstanding tax-exempt debt of the nonprofit. Under the bill, this transaction, in and of itself, would not adversely affect the income tax exemption for interest paid with respect to the tax-exempt debt. No new "private use" exemption for tax-exempt bonds would be created by this transfer: the bonds still would be devoted to the acquisition of student loan notes under federal programs, which is the intent underlying Internal Revenue Code section 150(d); moreover, the nonprofit sector would retain the benefit of the value of the net assets transferred through its economic interest in the successor corporation.

In essence, the bill would allow a scholarship funding corporation to convert to a for-profit corporation and maintain its operational efficiency by transferring all of its functions as a "going concern." By allowing a full and complete "going concern" transition, H.R. 2603 provides scholarship funding corporations the ability to immediately seek additional capital to support the direct loan phase-in period and to preserve their capabilities as independent service contractors to the Department of Education with respect to direct loans.6/

To meet the requirement of the election, the nonprofit must remain an organization described in section 501(c)(3) of the Internal Revenue Code after the transfer. Thus, the nonprofit would not continue to be limited to investing only in student loan notes issued under the Higher Education Act of 1965, but would be able to undertake the broader activities of an organization described in section 501(c)(3), such as charitable or other educational activities. The economic return received by the nonprofits from its investment in the successor would be a primary funding source for the nonprofit's exempt activities.

We recognize that an important aspect of this proposal is ensuring that the investment made by the nonprofits in the successor corporation is protected, both from an economic and

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6/ The concern has been raised that, after the transition, the scholarship funding corporations may not remain as participants in the federal student loan programs. Although we believe this concern is unwarranted, we would not object to reasonable statutory rules that require the successor corporations to serve the federal student loan programs; after all, this is our mission.

corporate governance standpoint. We continue to discuss these aspects with the staff of the Subcommittee, representatives of the Treasury Department and the staff of the Joint Committee on Taxation. We believe the outcome of these discussions will be an appropriate resolution of these concerns that does not place unnecessary burdens on the successor corporation's ability to raise additional capital to support private financing of student loans.7/

Solely as a result of the transfer of assets and liabilities to the for-profit corporation in exchange for the economic interest in that corporation, it is likely that the nonprofit would become subject to one of the excise taxes imposed on section 501(c)(3) organizations that are classified as private foundations (i.e., those section 501(c)(3) organizations that do not meet certain thresholds of financial support from the public). Under section 4943 of the Internal Revenue Code, private foundations that have "excess business holdings" are subject to an initial tax equal to 5 percent of the value of such holdings and an extremely onerous additional tax if the situation persists.

In view of the close relationship between the secondary market activities of the successor corporation after the transfer and the secondary market activities of the nonprofit scholarship funding corporation prior to the transfer, H.R. 2603 provides limited relief from the tax on excess business holdings attributable to the nonprofit's investment in the successor corporation. Under the bill, the excise tax under Code section 4943 for the "excess business holdings" of a private foundation will not apply with respect to the nonprofit's stockholdings in the successor corporation, but only so long as more than 50 percent of the gross income of the successor corporation is derived from, or more than 50 percent of the value of the assets of the successor corporation consists of, student loan notes.

This transition relief is narrowly crafted. It would apply only when the successor corporation is primarily servicing the same function after the transfer as the nonprofit served prior to the transfer. Significantly, it avoids unwanted competition between the nonprofit and the successor for equity investors in the successor corporation's stock during the transition, which would potentially drain capital from support of the federal student loan programs. This is an important consideration.

This limited exception to the excess business holdings rule of section 4943 is appropriate for two reasons. First, we believe that, from a corporate governance standpoint, it is necessary for a nonprofit which is making a substantial investment in the successor to have a voice in the direction of that corporation so it may protect its investment. Although the nonprofit should not be involved in the everyday business decisions of the successor, it should be able to express its approval or disapproval of major corporate transactions or other significant corporate matters commensurate with its interest in the successor. Second, the exception is necessitated by a change in federal policy as it affects an organization devoted to serving the prior federal policy. In contrast with many other statutory exceptions, this exception in fact would facilitate the implementation of the new federal policy.

7/ For example, these objectives perhaps could be accomplished by structuring the investment in the successor corporation as the most senior equity interest in the successor corporation, with features that would permit the investment to participate in the appreciation in value of the corporation yet protect the investment from downside potential.

Once a nonprofit scholarship funding corporation makes the election, we believe that neither the nonprofit nor the successor corporation should be allowed to issue additional tax-exempt debt. The proceeds of tax-exempt debt outstanding on the date of the transfer, in the hands of the successor corporation, will continue to support the student loan programs until that debt is retired. Moreover, any earnings benefit derived by the successor corporation from the tax-exempt debt will be fully subject to federal income tax.

IV.

Conclusion

We urge the Subcommittee to support the concept contained in H.R. 2603. This proposal offers a cost-effective means of bolstering the capital base of the secondary student loan market during the transition period and of assuring that the expertise and workforce of the scholarship funding corporations are maintained to provide services in furtherance of the federal student loan programs. In short, the proposal would permit scholarship funding corporations to evolve with the federal student policy, serve the recognized needs for capital and services provided by the private sector and, in this connection, compete with Sallie Mae to the benefit of the federal government and our nation's students.

The adoption of an amendment of this type will, we believe, also have the effect of increasing federal tax revenues by transferring this student loan activity from the tax-exempt to the taxable sector. We look forward to working with the Subcommittee to refine this proposal so that these goals can be accomplished.

APPENDIX

The Education Finance Council, Inc.

The Education Finance Council ("EFC") is a not-for-profit association organized to promote the common interests of tax-exempt education loan secondary market organizations whose mission is to maintain and expand student access to higher education opportunities by ensuring the availability of tax-exempt funding for education loans and fulfilling the resource needs of students and families pursuing post-secondary education. EFC, while only formed in December, 1992, currently represents the 23 nonprofit state-based secondary markets which are listed below.

As of December 31, 1992, nonprofit state secondary markets held at least $12 billion, or approximately 20%, of all outstanding FFEL Program Loans.

Arkansas Student Loan Authority
California Higher Education Loan Authority, Inc.
Central Texas Higher Education Authority, Inc.
CitiState Advisors on behalf of LA Public Facilities Authority
Colorado Student Obligation Bond Authority
Greater East Texas Higher Education Authority
Illinois Student Assistance Commission/IDAPP
Iowa Student Loan Liquidity Corporation
Maine Educational Loan Marketing Corporation
Michigan Higher Education Student Loan Authority
Mississippi Higher Education Assistance Corporation
Missouri Higher Education Loan Authority
Montana Higher Education Student Assistance Corporation
Nebraska Higher Education Loan Program, Inc.
North Texas Higher Education Authority, Inc.
New Jersey Higher Education Assistance Authority
Panhandle Plains Higher Education Authority
Pennsylvania Higher Education Assistance Agency
Southwest Texas Higher Education Authority, Inc.
The Student Loan Funding Corporation
Utah Higher Education Assistance Authority
Vermont Student Assistance Corporation
Volunteer State Student Funding Corporation

Mr. KOPETSKI. I want to remind the panelists that we have seven panels today. I know some of you probably have airplanes at 5 o'clock that you would want to catch after your testimony. If we could adhere as closely as possible to the 5-minute rule, we will all make our airplanes and other places that we have to be later this afternoon.

With that, we have Mr. Uvena. Welcome.

STATEMENT OF FRANK UVENA, SENIOR VICE PRESIDENT, LAW AND CORPORATE STAFFS, R.R. DONNELLEY & SONS CO., CHICAGO, ILL.

Mr. UVENA. I am Frank Uvena, senior vice president, law and corporate staffs of R.R. Donnelley & Sons Co. As such, I have held responsibility for employee benefits, and for human resources. I am not a tax expert.

R.R. Donnelley is a leader in managing, reproducing and distributing print and digital information services, worldwide. We are 129 years old. Our total current employment is 32,000, mostly in the United States. More than 11,500 of our employees have been with us for more than 10 years.

I appreciate the opportunity to appear before you today to offer my company's view on an issue of importance to us. I would also like to thank Congressman Reynolds for helping us bring this matter before you.

I am here to propose that the committee consider the reinstatement of a tax credit that was in effect until 1987. That provision allowed employers a tax credit of three-quarters of 1 percent of the compensation due to employees provided that the entire amount was contributed to an employee stock ownership plan to purchase stock to be distributed only to employees. This particular variety was known as a PAYSOP. The tax credit was initiated by Congress to encourage widespread stock ownership by employees of American companies. Our company adopted this plan in 1981. Our plan was designed for the broadest possible employee participation. We made it available to everyone with at least 1 year's full service, and we paid all costs of administration to ensure that the entire credit would be used only to acquire stock. The plan was so popular that by 1987 75 percent of our full-time employees in the United States were participating and held over 1,750,000 shares they had received through the PAYSOP.

It is clear the PAYSOP tax credit, as it existed in 1986, was an important contribution to employee morale, an effective way of enhancing commitment, of encouraging employees to feel a relationship beyond employee-employer, to feel a real sense of ownership in the company.

I believe this was Congress' intent in enacting the program in the first place. It clearly worked at Donnelley. It worked because it was available to all employees. It worked because it was simple in operation. It worked because it was easy to understand, and, most important, it worked because it benefited employees directly. I know our employees were surprised and disappointed by the Government's decision to drop the program after 1986. We discontinued further funding of the program in 1987 when tax credits were no longer available. This decision underscores a fundamental point which I would like to emphasize. We have never considered the PAYSOP plans as in way a substitute for retirement benefits or for other employee benefits generally.

If the Congress sees fit to reinstate the program, we will participate enthusiastically, but we have no intention of using it to replace any employee benefits now in place. The change will benefit our employees only. It will not add a penny to Donnelley's earnings.

Let me now address the PAYSOP issue in a somewhat broader context. All of us know that American businesses are participants in a highly competitive global economy. It is essential all employees be empowered to think and act much like business owners. We feel strongly stock ownership can help to foster such an attitude and reward such work and sacrifice.

We all know in an effort to remain competitive and productive in a global marketplace, American businesses have sharply reduced the number of middle managers and, indeed, the number of core employees generally. This makes it all the more important all employees see themselves as partners in the business.

Let me summarize. The overall goal of our proposal is to put stock into the hands of all employees. This will help foster an attitude of ownership, a long-term view of employment and its benefits, and therefore, ultimately, higher productivity.

Past experience demonstrates that the PAYSOP was an effective mechanism for sharply increasing stock ownership by all employees. It was easy to understand, simple to administer, and all its benefits flowed directly to the employees.

We ask for reinstatement of the PAYSOP tax credit which existed prior to the Tax Reform Act of 1986. Your staff will shortly provide an estimate of the revenue impact of this proposal. Although clearly preferring and strongly recommending reinstatement of the credit as it existed in 1986, we do suggest several other options the committee may want to consider. They are set forth in my written statement.

In conclusion, what we advance here today will allow our Government to reinstate a simple, proven and effective mechanism for substantially increasing stock ownership among the working people of America. This in turn will make a major contribution to America's economic prospects for the future.

Thank you for your time and attention.

Mr. KOPETSKI. Thank you very much for your testimony.

[The prepared statement follows:]

TESTIMONY OF FRANK J. UVENA
R.R. DONNELLEY & SONS CO.

Good Morning Mr. Chairman, Members of the Committee -

My name is Frank Uvena. I am Senior Vice President, Law and Corporate Staffs, of RR Donnelley & Sons Company. As such, I have held responsibility for employee benefits, for human resources and for corporate staff functions which emphasize high employee involvement and quality management.

RR Donnelley is a leader in managing, reproducing and distributing print and digital information services world wide. As the world's largest commercial printer, we produce catalogs, newspaper advertising inserts, magazines, books, directories, financial printing and computer documentation. Our total current employment is about 32,000, with most of our employees in the United States.

I very much appreciate the opportunity to appear before you today to offer my company's view on an issue of importance to us.

I am here to propose that the Committee consider the reinstatement of a tax credit that was in effect until 1987. That provision allowed employers a tax credit of 0.75% of the compensation due to employees, provided that the entire amount was contributed to an Employee Stock Ownership Plan, to purchase stock to be distributed only to employees. This particular variety was known as a PAYSOP. The tax credit was initiated in 1981 to encourage wide-spread stock ownership by the employees of all types of American companies.

My company adopted such a plan in 1981. From the beginning, our plan was designed for the broadest possible employee participation. We made it available to everyone with at least one full year of service, and we paid all costs of administration to ensure that the entire credit would be used only to acquire stock. The plan was so popular that by 1987 some 75% of all of our full time employees in the United States were participating. At that time our employees held 1,752,220 shares they had received through the PAYSOP.

Our employees understood and appreciated the stock ownership rights obtained under the program. For generations at Donnelley, members of senior management have met with all employees regularly to discuss the state of the company and to receive employee questions, comments and criticisms. As one of the Donnelley executives regularly involved in these meetings, I know that employees frequently asked questions about their benefits and rights under the PAYSOP plan. I know it gave them an important feeling of ownership, of partnership in their company. I can also testify they were surprised, dismayed and disappointed when this benefit was no longer available after 1986. They simply never understood why it was discontinued by the government.

Based on our objective statistics on employee participation, and the personal experience which I have just described, which was shared by my colleagues in the senior management of the company, it was clear the PAYSOP tax credit as it existed in 1986 was an important contribution to employee morale and an effective way of enhancing commitment, of encouraging employees to feel a relationship beyond employee-employer, to feel a real sense of ownership in their company. I believe this was Congress's intent in enacting the program in the first place. It clearly worked at Donnelley. It worked because it was available to all employees, simple in operation, easy to understand and, most important, benefitted employees directly.

We discontinued further funding of the program in 1987 when tax credits were no longer available. As I mentioned, at that time approximately 75% of our employees in the United States were participants in the plan and thereby Donnelley stock holders.

One might well ask why Donnelley withdrew from the program entirely at that time, when, as you know, a number of provisions permitting Employee Stock Ownership Plans remained in the law, and are indeed still there today? This is a fair question. In our view, the remaining provisions governing ESOPs are intended to serve purposes quite different from that of the plan in which we participated. Some such provisions were intended to apply primarily to closely held corporations and their stockholders. Other provisions allowing for an effective deduction of ESOP loan payments helped facilitate stock buyouts on a highly leveraged basis. Finally, some companies used ESOP incentives to radically change their benefit structure for employees, so as to feature an ESOP as the predominant benefit available.

In short, as the law currently stands, the ESOP tax incentives are designed to further the business purposes of certain corporate entities and their stockholders by providing favorable means of transferring shares, obtaining less costly financing or a less expensive package of benefits.

We of course have examined and carefully considered these possibilities. The first two clearly did not apply to us. With respect to benefit packages, we already had what we regarded as an extraordinarily attractive benefit package, that was understood by and effective for, our employees generally. We saw no reason to change it.

This decision underscored a fundamental point which I should like to emphasize. We never considered the PAYSOP plans as in any way a substitute for retirement benefits or for other employees benefits generally, and we do not do so now. If the Congress sees fit to reinstate the program, we will participate enthusiastically, but we have no intention of using it to replace any employee benefits now in place. The change will benefit our employees only; it will not add a penny to Donnelley's earnings.

I should now like to take a moment to place the PAYSOP issue in a somewhat broader context. All of us know that we are participants in a highly competitive global economy. If individual American companies and American industry generally are to remain competitive in the world marketplace, we must anticipate customers' needs, respond to those needs more quickly, deliver the quality the customers demand, and do all of this at a very competitive price. We feel that this sort of response, with the needed level of innovation and quality control, is impossible, unless we empower our hourly employees to participate fully in the operation of the company. This revolutionary new corporate culture often requires our employees to think and act and make sacrifices much like those of a small business owner. We feel strongly that to foster such an attitude and to reward such work and sacrifice, all employees should actually be owners, and participate in the long-term benefits of stock ownership.

You gentlemen all know that in an effort to remain competitive and productive in a global marketplace, American business has sharply reduced the number of middle managers and, indeed, the number of core employees generally. The wide-spread anxiety and pain resulting from this unavoidable process make it all the more important that our employees generally see themselves as partners in the business, feel that they have a real stake beyond, although certainly not instead of, the regular pay check. At this point you might ask: This is very persuasive. It sounds like an excellent program. So, why don't you just go ahead and do it? Why are you here talking to us? To answer that question, I must again emphasize the rigorous competitiveness of the environment in which we operate. Our wage levels rank near the top of our industry and compare very favorably to industry generally. Our employee benefits, such as insurance, healthcare, and a fully funded retirement plan, are, we think, generous. In view of the very narrow profit margins under which we must operate in these difficult days, we cannot afford to do more.

Most companies have gone through or are going through dramatic and difficult changes to reduce their costs and remain competitive. Adding additional costs is simply not an option for such companies in today's economic environment.

Many employees are struggling to maintain their standard of living. They could not easily accept a conversion of their current cash compensation to mostly cash with some employers' stock. It follows that in the current environment, broadened employee stock ownership will not occur without significant support by the United States government.

Let me summarize.

The purpose:

The overall goal is to put stock into the hands of all employees. This will help to foster an attitude of ownership, a long term view of employment and its benefits, and therefore, ultimately, higher productivity.

Past experience demonstrates that the PAYSOP was an effective mechanism for sharply increasing stock ownership by rank and file employees. It was easy to understand, simple to administer, and all its benefits flowed directly to the employees.

ESOP provisions in the current Internal Revenue Code focus on more narrow, targeted groups, such as closely held corporations, LBO's and corporations needing to restructure their benefits plans. As a result, ESOP, as it appears in the current law, is really oriented to favor the corporate entity or investment community. This is not our purpose.

Our Proposal

We ask for reinstatement of the 0.75% PAYSOP tax credit which existed prior to the TAx Reform Act of 1986. It was formerly codified as Sec. 44G of the Internal Revenue Code of 1954.

Some revenue impact from such a program is inescapable. It is our understanding that the staff of this Committee hopes to have available an estimate of the amount of this impact on or about September 14th, so it is pointless for me to speculate at this juncture as to what those numbers might be. However, in order to limit the revenue impact of this proposal RR Donnelley, although clearly preferring and strongly recommending reinstatement of the credit as it existed in 1986, is suggesting several options the Committee may want to consider. All of them will achieve the primary goal, the increase of stock ownership by lower compensated employees.

- Option One - Limit the contribution and tax credit to $450 per employee. This figure is derived by limiting the contribution to 0.75% of compensation up to a maximum of $60,000.
- Option Two - Limit the credit to the compensation only of "non-highly compensated" employees. The definition of such employees would be that presently set out in the Internal Revenue Code.
- Option Three - Provide the 0.75% tax credit, but require a distribution of stock from the plan to each employee within four years of the contribution by the employer. This would trigger taxation to the employee on the value of the stock as of the date of distribution, and therefore reduce the tax loss to the government.
- Option Four - Reduce the tax credit to 0.5% of compensation, the provision which was in effect for the tax years 1983 and 1984. To limit the revenue impact further, Option Four could be combined with Option One or Two and Three.

We believe that Options One and Two are essentially interchangeable and are clearly preferable to Options Three and Four. They provide different ways to approach the same issue. The third option is least preferred because it would have the effect of reducing the amount of stock held by employees in the long term.

Conclusion

The proposals advanced here will allow our government to reinstate a simple, proven and effective mechanism for substantially increasing stock ownership among the working people of America. When combined with sweeping internal corporate changes, variously termed high employee involvement or employee empowerment, the proposal will significantly improve productivity. This, in turn, will make a major contribution to America's economic prospects for the future.

Mr. KOPETSKI. Mr. Romeo.

STATEMENT OF RICHARD P. ROMEO, CHAIRMAN, TAX COMMITTEE, AMERICAN FINANCIAL SERVICES ASSOCIATION, AND VICE PRESIDENT AND GENERAL TAX COUNSEL, AMERICAN EXPRESS TRAVEL RELATED SERVICES CO., INC., NEW YORK, N.Y.

Mr. ROMEO. Thank you, Mr. Chairman and members of the subcommittee. I am Richard P. Romeo, vice president, general tax counsel of American Express Travel Related Services Co., Inc., in New York.

Today, I am testifying on behalf of the American Financial Services Association (AFSA), which is the Nation's largest trade association representing nonbank providers of consumer financial services.

We have a more detailed written statement that we would like to submit for the record.

Today, we appreciate the opportunity to testify in support of a proposal to clarify when a debt will be considered worthless for tax purposes so that a deduction may be obtained. AFSA urges your support for this proposal since it would achieve substantial simplification of current law, would assure that taxpayers in similar businesses will be treated similarly for tax purposes, and would have little or no adverse revenue impact.

Under current law, deductions for bad debts are allowed only in the year in which the debts become worthless. For companies like AFSA members, which typically have a high volume of relatively small loans and receivables, proving worthlessness on a loan-by-loan basis is a cumbersome and time consuming, if not impossible, task.

For regulated financial institutions such as banks and thrifts, Treasury regulations now afford a conclusive presumption allowing conformity of financial accounting and tax treatment for worthless debts. No such standard applies to unregulated creditors such as AFSA members, even though they compete with regulated lenders and hold similar loans and receivables.

In connection with the repeal of the reserve method by the Tax Reform Act of 1986, Congress directed the Treasury Department to study and issue a report on bad debt deductions. In its report, Treasury acknowledged the fundamental similarities between banks and nonbank financial services companies, and the problems that nonbanks face without a similar bad debt standard.

One approach considered by Treasury for nonbank creditors would be to determine worthlessness for tax purposes by reference to the standards set by bank regulatory authorities. Treasury's evaluation of this approach was largely favorable, and it was determined to involve an insignificant revenue effect. However, Treasury concluded that extending a book-tax conformity rule to creditors other than regulated lenders should be introduced with congressional approval rather than by unilateral regulatory action.

It is important to note that the proposed rule would not impose a book-tax conformity rule for all bad debt deductions. Rather, it would apply only with respect to those types of debts for which bank regulators prescribe specific, objective rules that can be readily applied by taxpayers and the Internal Revenue Service. This would have the effect of limiting the presumption to those low balance, high volume loans and receivables for which the administrative burdens of proving worthlessness on a loan-by-loan basis are most readily apparent.

The Treasury Department has raised concerns about this proposal for reasons that appear to give insufficient weight to the basic principle of competitive equality that underlies AFSA's support. We are confident that Treasury's concerns may be satisfied.

First, the current book-tax conformity rule for banks and other regulated institutions was found by Treasury in its report on bad debts to be supported by general tax principles and not by any special status of regulated entities.

Second, the use of specific, objective criteria for worthlessness, such as the length of delinquency, in the case of consumer installment loans and credit card debt, would help assure that chargeoff standards will be uniform for all creditors with similar types of loans and be relatively easy to administer for both taxpayers and the IRS.

Third, the oversight and expertise regulators bring to this issue is embodied almost entirely in establishing the objective chargeoff criteria and not in performing detailed audits, thus making moot the absence of regulatory oversight of other taxpayers that seek to apply those same rules.

Finally, AFSA maintains that unregulated creditors would be no more prone to take advantage of a book-tax conformity rule to accelerate tax deductions than would their regulated competitors. In any event, the ability to accelerate chargeoffs would be precluded since bad debt deductions would be allowable no earlier than the time specified in the appropriate regulatory guidelines.

In conclusion, I would like to thank the chairman and the members of the subcommittee for their attention this morning. My own company as well as other members of AFSA are interested in this and other pending tax legislative proposals that raise a similar issue regarding comparable tax treatment for competitors in the financial services industry.

We appreciate the opportunity we have had to meet with congressional and Treasury staff to discuss this issue, to provide information regarding our industry and to attempt to develop a workable rule that reflects sound tax policy. We look forward to continuing to work with you and the staff on these issues as the legislative process progresses.

Mr. KOPETSKI. Thank you for your testimony.

[The prepared statement follows:]

AMERICAN FINANCIAL SERVICES ASSOCIATION

TESTIMONY REGARDING BAD DEBT DEDUCTIONS OF NON-BANK CREDITORS

SUBCOMMITTEE ON SELECT REVENUE MEASURES OF THE HOUSE WAYS AND MEANS COMMITTEE

SEPTEMBER 8, 1993

Introduction

Good morning, Mr. Chairman and members of the Subcommittee. My name is Richard P. Romeo, Vice President - General Tax Counsel of American Express Travel Related Services Company, Inc.

Today, I am testifying on behalf of the American Financial Services Association (AFSA). AFSA is the nation's largest trade association representing non-bank providers of consumer financial services. Organized in 1916, AFSA represents 367 companies operating 10,910 offices engaged in extending over $200 billion of consumer credit throughout the United States. These companies range from independently-owned consumer finance offices to the nation's largest financial services, retail, and automobile companies. Retail and automobile credit is extended through thousands of stores and dealers. Consumer finance companies hold over $150 billion of consumer credit outstanding and $67 billion in second mortgage credit, representing one quarter of all consumer credit outstanding in the United States.

We appreciate this opportunity to testify in support of a proposal to clarify when a debt will be considered worthless for tax purposes so that a deduction may be obtained. In general, the proposal would allow creditors with a high volume of low balance, homogeneous loans to establish worthlessness by reference to the standards that have been provided for banks and other regulated institutions. AFSA's support for this proposal is based upon the belief that it would achieve substantial simplification of current law, would assure that taxpayers in similar businesses will be treated similarly for tax purposes, and would have little or no adverse revenue impact.

Why New Legislation on Bad Debt Deductions Is Necessary

The need for new legislation in this area stems from the repeal of the reserve method for bad debts by the Tax Reform Act of 1986. Under the reserve method, deductions had been allowed for additions to a reserve for bad debts for charge-offs that were expected to occur in the future.

Since the repeal of the reserve method, deductions for bad debts have been allowed only in the year in which the debts become worthless (or worthless in part) and charged off. For companies like AFSA members, which typically have a high volume of relatively small loans and receivables, proving worthlessness on a loan-by-loan basis is a cumbersome and time consuming, if not impossible task. In addition to the resources required on the part of both taxpayers and the Internal Revenue Service in audits of bad debt deductions, taxpayers face the risk that the IRS would propose disallowances of claimed deductions that may not be easily disproven on a loan-by-loan basis.

For regulated financial institutions such as banks and thrifts, Treasury regulations now afford a conclusive presumption allowing conformity of financial accounting and tax treatment for worthless debts. There is no such standard that applies to unregulated creditors such as AFSA members, even though they compete with regulated lenders and hold similar loans and receivables. In our view, this disparity in treatment of similarly situated taxpayers is unnecessary and unfair, and this legislative proposal is an appropriate response to the problem.

The Treasury Department Report to the Congress on Bad Debts

In connection with the repeal of the reserve method for bad debts in 1986, Congress directed the Treasury Department to study and issue a report on "appropriate criteria to be used to determine if a debt is worthless" for tax purposes, and to "consider under what circumstances a conclusive or rebuttable presumption of the worthlessness of an indebtedness is appropriate" (H. R. Conf. Rep. No. 841, 99th Cong. 2d Sess. II -316 (1986)).

While AFSA closely monitored the progress of the Treasury Department study and was even afforded the opportunity to provide input concerning the business of its members, the conclusions and recommendations that resulted from the study essentially left our industry in limbo.

In its report ("Report to the Congress on the Tax Treatment of Bad Debts by Financial Institutions", Department of the Treasury, September 17, 1991) (hereinafter "Treasury Report"), Treasury defended the book-tax conformity rule that applies to regulated lenders on the ground that "the regulatory and tax definitions of assets that should be charged off are quite similar in that they are both based on apparent uncollectibility, notwithstanding the possibility of partial recovery at some time in the future" (Treasury Report, page 22).

While noting that the book-tax conformity approach was available only to regulated lenders, Treasury did acknowledge the fundamental similarities between the lending activities of non-bank financial services companies and banks, and the problems that non-banks face without a similar bad debt standard:

> "These nondepository institutions resemble regulated lenders in a number of ways. They typically hold large portfolios of homogeneous loan receivables. Like large banks, they are not permitted to use the reserve method in computing the deduction for bad debts. As a consequence, they face similar difficulties in evaluating the quality of assets in their portfolios on a loan-by-loan basis for purposes of determining their bad debt deductions. But because they are not subject to the regime of state and federal regulation that governs depository institutions, the conclusive presumption allowing conformity of tax and book treatment of worthless debts is not available to them. Therefore, in the absence of the reserve method, these taxpayers must use the specific charge-off method for deducting worthless debts and support such deductions with 'all pertinent evidence' if challenged by the Internal Revenue Service.
>
> In view of many similarities between these unregulated lenders and depository institutions and the burdens imposed by the loan-by-loan analysis required under the specific charge-off method, it is worthwhile to consider whether such lenders should

> have some sort of book/tax conformity rule now available to banks and thrifts." (Treasury Report, page 29)

Treasury expressed the view that because of the absence of regulatory oversight, a book-tax conformity rule for such creditors should be qualified by some additional standard to deter overly aggressive charge-off policies to obtain tax advantages. Among the various approaches that could be used in "developing a proxy for regulatory oversight" is the so-called "identical standards" approach, which most closely approximates the proposal under consideration. Under this approach, the determination of worthlessness for tax purposes of particular types of debts held by any creditor, whether or not regulated, would be determined by reference to the standards set by bank regulatory authorities. Treasury's evaluation of this method was largely favorable:

> "The identical standards approach is appealing in that it adopts identifiable objective standards for determining worthlessness and seeks to create parity between the treatment of regulated and unregulated lenders with respect to similar types of loans . . . . (W)e believe the substance of this proposal may provide a promising basis for the development of a workable conformity rule and would have an insignificant revenue effect." (Treasury Report, page 31)

Treasury concluded that extending a book-tax conformity rule to creditors other than regulated lenders would be a departure from settled policy and practice that should be introduced with Congressional approval rather than by unilateral regulatory action. This is what prompted the introduction of the legislative proposal now under consideration.

How the Proposed Rule Would Operate

It is important to note that the proposal would not impose a book-tax conformity rule for all bad debt deductions. Rather, a conclusive presumption of worthlessness would be provided only with respect to those types of debts for which bank regulatory authorities have prescribed specific, objective rules that can be readily applied by taxpayers and the Internal Revenue Service. To the extent that regulatory authorities require an examination of all facts and circumstances relating to a particular loan, rather than such objective criteria, there would be no presumption of worthlessness based upon book-tax conformity. This would have the effect of limiting the presumption to those low balance, high volume loans and receivables for which the administrative burdens of proving worthlessness on a loan-by-loan basis are most readily apparent.

Thus, the Treasury Report notes that the Comptroller of the Currency's Handbook for National Bank Examiners adopts mechanical, automatic charge-off procedures for high-volume loans (such as consumer installment loans, credit card plans, and check credit plans) that look solely to the time the debt has been delinquent. Similar rules regarding "consumer credit" have been promulgated by the Office of Thrift Supervision (12 C.F.R. § 561). Instead of performing a loan-by-loan review, a bank examiner confirms that the proper automatic charge-off procedures have been adopted and followed. Use of a similar approach by IRS auditors examining nondepository financial services companies would significantly diminish audit burdens for both taxpayers and the IRS and bring much-needed certainty to the issue of deductions for worthless debts. In addition, it is important to note Treasury's conclusion that basing a book-tax conformity rule for nondepository providers of consumer financial services on an "identical standards" approach "would have an insignificant revenue effect."

The approach of bank regulators in determining worthlessness on the basis of a single fact, length of delinquency, may appear to depart from tax precedents calling for consideration of "all pertinent evidence." However, Treasury noted that the unsecured nature of most consumer debt "may cause that single fact to be an adequate measure of worthlessness for tax purposes. In any event, the high volume of such loans and their comparatively low face value would make an in-depth inquiry into all relevant facts and circumstances a very burdensome task for the lending institution" (Treasury Report, page 23).

Response to Treasury Department Concerns About the Proposal

The principle that underlies AFSA's support for this proposal is that there should not be a disparity in the tax rules for bad debt deductions applicable to competitors in the financial services industry based solely upon whether or not a taxpayer is regulated for non-tax purposes. In this regard, we note that the Treasury Department has submitted testimony in opposition to the proposal for reasons that appear to conflict with this basic principle of competitive equality. We are confident that Treasury's concerns may be satisfied, and we would like to address those concerns for the record at this time.

The written comments on this issue submitted to this Subcommittee on June 22, 1993 by Assistant Secretary of the Treasury (Tax Policy) Leslie B. Samuels provided as follows:

> "The rules concerning bad debts of federally regulated financial institutions recognize their special status which is not shared by non-federally regulated institutions. There are no assurances in the case of unregulated lenders that the debts will be worthless under general tax principles when charged off for book purposes, or that uniform charge-off standards will be applied. In addition, the absence of federal regulatory oversight provides unacceptable opportunities for distortions, particularly in the form of accelerated charge-offs."

The concerns expressed by Assistant Secretary Samuels were in large part addressed in the Treasury Department's own report to the Congress on bad debt deductions cited earlier in this statement. Thus, the special book-tax conformity rule that now applies with respect to the bad debt deductions of banks and other regulated institutions is not based merely upon their "special status" as regulated entities. Rather, Treasury viewed that rule as justified by the fact that "the regulatory and tax definitions of assets that should be charged off are quite similar in that they are both based upon apparent uncollectibility, notwithstanding the possibility of partial recovery at some time in the future" (Treasury Report, page 22). Even where a single fact, the length of delinquency, determines worthlessness for regulatory purposes of consumer installment and credit card debt, Treasury was satisfied that "it is appropriate to permit the regulatory loss classification to determine the worthlessness of such debts for tax purposes" (Treasury Report, page 23).

In short, even though regulators might be expected to have a more conservative approach to bad debt charge-offs than tax auditors, Treasury concluded that the regulatory criteria were in fact consistent with the "general tax principles" referred to by Assistant Secretary Samuels. We submit that this should be true whether or not the particular taxpayer whose debts the criteria are applied to is regulated.

We believe that the concern that the charge-off standards to be applied should be "uniform" would be satisfied by the relatively limited scope and terms of the proposed rule. As stated earlier, the rule should apply only to those specific types of debts characterized by their relatively high volume and low balances for which regulators prescribe specific, objective criteria for worthlessness (such as the length of delinquency, in the case of consumer installment loans and credit card debt). In the case of other types of loans for which a more subjective, "facts and circumstances" analysis is made by regulators, there would be no book-tax conformity presumption. Relying solely upon objective criteria should alleviate any concern regarding uniformity.

The concern that the absence of federal regulation presents unacceptable opportunities for tax avoidance overstates the role regulators perform with respect to the types of loans in question. Instead of a loan-by-loan review, an on-site examination of a bank by a regulator is limited to "confirming that the proper automatic charge-off procedures have been adopted for installment and credit card loans" (Treasury Report, page 16). Thus, the oversight and expertise regulators bring to this issue is embodied almost entirely in establishing the objective charge-off criteria that may be applied to loans held by any creditor, whether regulated or unregulated. The absence of detailed regulatory audits with respect to such loans tends to make moot the absence of regulatory oversight of other taxpayers that seek to apply those same rules. Further, the relatively streamlined audit inquiry into whether an institution's charge-off procedures comply with objective regulatory standards confirms the administrative advantages of this approach and responds to the administrative concerns Assistant Secretary Samuels cited in his oral testimony.

AFSA maintains that unregulated creditors would be no more prone to take advantage of a book-tax conformity rule to accelerate tax deductions than would their regulated competitors. Unregulated finance companies, like banks, need to report strong earnings to maintain their good standing with debt rating agencies, creditors and shareholders. In any event, since bad debt deductions would be allowable no earlier than the time specified in the appropriate regulatory guidelines, the ability to accelerate charge-offs to obtain earlier tax deductions for bad debts would be precluded.

Assistant Secretary Samuels also stated that smaller, privately-held lenders would be disadvantaged if the proposal would apply only to their publicly-held competitors. AFSA agrees with this concern. A tax standard for bad debt deductions that is based upon objective criteria set forth by bank regulators should be available to all taxpayers, regardless of whether they are public or private, regulated or unregulated.

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I would like to thank the Chairman and the members of the Subcommittee for their attention this morning. My own company as well as other members of AFSA are interested in this and other pending tax legislative proposals that raise a similar issue regarding comparable tax treatment for competitors in the financial services industry. We appreciate the opportunity we have had to meet with Congressional and Treasury staff to discuss this issue, to provide information regarding our industry and to attempt to develop a workable rule that reflects sound tax policy. We look forward to continuing to work with you and the staff on these issues as the legislative process progresses.

Mr. KOPETSKI. I want to begin questioning with Mr. O'Toole.

Organizations such as Nellie Mae have been subsidized generously by Federal tax benefits in the past. Now you feel that you could better serve the needs of student borrowers by converting to for profit status. Why the change in philosophy?

Mr. O'TOOLE. Thank you, Mr. Chairman.

Organizations such as ours have been nonprofit organizations from the start as required by the code. All of the earnings or the accumulation of net assets that have been created over that period of time, since the beginning of those organizations' existence, would stay within those organizations and be dedicated to nonprofit purposes, broader nonprofit purposes, than just the Federal student loan programs but still purposes associated with fostering educational opportunity in a nonprofit sense.

Our suggestion is that in order to meet the student loan funding needs during the 4-year transition period that we be permitted to establish a successor corporation under the rules and restrictions set out in H.R. 2603. We are expecting that under the current law private lending will be phased down from the current program volume, but that demand will not change. We are expecting that organizations such as ours, that are among the largest providers of student loan capital in the country which support Federal programs, will be called upon to provide still greater levels of student loan funding in response to phase down of private funding. With the changes to the current program enacted by the Congress and developed by the education committees, there will be greater difficulty during the transition in raising funds sufficient to meet the student loan capital needs because of the reductions in yields and the greater risk sharing associated with student loans. Thus, we are looking for an opportunity to be able to strengthen the balance sheet of our organizations by injections of equity investment that would allow us to then leverage that equity investment to greater levels of debt financing to meet those student loan capital needs in support of the student loan program during the transition.

Mr. KOPETSKI. Mr. Hoagland, do you have any questions of Mr. O'Toole?

Mr. HOAGLAND. Not of Mr. O'Toole.

Mr. KOPETSKI. Mr. Uvena, under your proposal there would be a great expansion of ESOPs as a means of providing employee retirement benefits. Prior laws which provided tax favored treatment for ESOPs resulted in providing greater tax benefits to employers and others engaged in ESOP transactions without ensuring increased rights of ownership for participating employees. Can we expect to see a recurrence of similar concerns under your proposal?

Mr. UVENA. I would hope not. There are other laws governing ESOPs which remain and serve legitimate purposes. What we suggest, it be reinstated is a very narrow one directed just to provide stock to employees. In our company we have a fully funded defined benefit retirement plan which will not change, which did not change during this period of time. In fact, it was very clear that this was a tax funded benefit and that was clearly communicated to our employees. It was never a substitute for compensation, for retirement or any other benefits.

Mr. KOPETSKI. I see.

Mr. Romeo, are members of your association prepared to accept other tax rules applicable to your competitors in the financial services area? For example, the recently passed budget reconciliation bill contains a provision that would require banks and thrifts to report to the IRS with respect to discharges of indebtedness in excess of $600. Would you object if this reporting requirement were extended to all companies engaged in the business of making loans?

Mr. ROMEO. We are very much aware of that provision. It was added in the recently enacted bill, and it only applies to regulated institutions. While we believe that there is an insignificant revenue effect with regard to the bad debt proposal, we think extending the reporting requirement would be consistent with the idea of competitive equality and parity so that the same rule should apply.

In fact, many of us have regulated institutions within our consolidated groups and do in fact have to comply with that rule as to those entities anyway. We think an extension of the rule would be consistent with the principle that underlies our support for the bad debt rule. So, yes, Mr. Chairman, we have seen it linked. There is not necessarily a quid pro quo between the bad debt and information reporting proposals, but they certainly stem from the same principle of treating all competitors in the financial services industry on a level playing field.

Mr. KOPETSKI. I appreciate your openness. Mr. Hoagland.

Mr. HOAGLAND. Let me say, Mr. Romeo, that I am pleased that you specifically addressed Treasury's concerns in your testimony.

Mr. Samuels indicated reservations earlier, and you have addressed those reservations and I concur with your analysis.

Let me indicate that my staff is currently working with American Express and other members of the association together with Joint Tax to gather the information necessary to develop legislation that will satisfy Treasury and at the same time provide a method that will permit nonbank lenders to establish the worthlessness of low balance, homogeneous loans by reference to standards similar to those that have been provided for banks and thrifts. I think we ought to be able to do it, don't you?

Mr. ROMEO. Yes, sir. I thank you for your interest in this issue and your efforts in getting it into the legislative arena and under discussion at this time.

Mr. HOAGLAND. We have a rule for regulated institutions, banks and thrifts that works well, and I think there is no reason we can't extend that to nonbank institutions.

Mr. ROMEO. In that regard I wish to emphasize that we are not talking about a blanket, across-the-board parity rule under which whatever is deductible for book purposes should be deductible for tax purposes. We are talking about a more limited class of loan, the relatively low balance, high volume situation. Some of our companies, like banks, have millions of these types of accounts, such as consumer installment loans, credit card debt, et cetera. The ability to be able to look at those on a loan-by-loan basis is simply an impossible task.

Those are the type of loans for which regulators have specified some fairly workable rules that can be applied by anybody who has that type of loan. That is essentially the standard we are seeking to adopt here and have available for tax purposes.

Mr. HOAGLAND. It would simplify the process for IRS and all companies involved?

Mr. ROMEO. Yes, sir. We think it is very much a step toward administrative simplification. Having a bright line test, while it may be rough in some regard, certainly would be easier to administer, minimize audit burdens, and minimize the time and resources and effort that has to be expended by both taxpayers and IRS in auditing this type of issue.

Mr. HOAGLAND. I don't think it is in the interest of IRS or the industry to be required to determine the worthlessness to these loans on a loan-by-loan basis and we can and should move to a more efficient system.

Mr. ROMEO. We agree and appreciate your support for that effort. We certainly do think it is very much an open issue. There are some details that we need to work out with congressional and Treasury staff and we certainly are very eager to continue with that process.

Mr. HOAGLAND. Let's hope we can get it done. Thank you, Mr. Chairman.

Mr. KOPETSKI. I thank the panelists and thank you for your expert advice and opinion and written testimony and brevity.

We will now move to the next panel, panel three out of seven panels today. We will move to the advertising arena with the Committee for Competition Through Advertising, Gerald Gibian, Corporate Vice President, Tax and Real Estate, Estee Lauder Co., N.Y.; the Ad Hoc Group to Preserve Deduction for Advertising, Mark McConaghy, former chief of staff of the Joint Committee on Taxation; and the Advertising Tax Coalition, Timothy White, publisher, Times Union, Albany, N.Y. With him is DeWitt Helm, president, Association of National Advertisers of New York. Welcome, gentlemen.

Before I begin the testimony, I want to have a statement of my own entered into the record. I have an advertising public relations background. I will let my bias be known immediately.

I believe firmly that advertising goes into a product just as much as the research and development to develop the product and the raw materials to make the product. We recognize that in our legal system, stressing the importance of our copyright laws.

If you look at all the trade negotiations, one of the centerpieces of dispute is enforcement of the intellectual property rights because they get abused. One of the reasons why American products are so valuable is the amount of money and creativity that goes into the advertising of that product.

With that prejudgment on my part, I will now turn to Mr. Gibian from Estee Lauder Co. We are under I hope a 5-minute rule.

[Mr. Kopetski submitted the following:]

SUGGESTED STATEMENT

MR. KOPETSKI

Mr. Chairman, I would like to voice my opposition to the proposal to limit the deduction for advertising expenses -- this proposal is tantamount to a tax on advertising. Such a tax could seriously disrupt the economy, reduce competition among businesses and products and discriminate against small businesses as well as minority and small media outlets. It also would levy higher taxes on companies solely because they have large advertising budgets, and reduce the public's access to news, information and entertainment.

The tax treatment of advertising costs is governed by the same general principles applicable to all other business expenses. The recurring nature of an expenditure in roughly the same amounts each year suggests that the benefits of the expenditure do not last beyond the year. This feature is characteristic of virtually all advertising expenses. Moreover, no element of advertising costs is viewed by Congress or Treasury as a tax expenditure.

Advertising is the most economically efficient means of marketing a product to a mass society. Advertising allows producers to deliver goods and services more efficiently and it permits consumers to significantly improve their standards of living because it enhances their knowledge of and their access to better quality, lower priced products.

Any change in the tax law that makes advertising more expensive also is likely to discourage some companies from introducing new products. If new entrants cannot advertise as effectively and efficiently they will have a lower probability of success.

At a time when Treasury and the Congress are looking at ways to simplify the tax code, a law which defers a deduction for "advertising" expenses would add complexity and be too imprecise to be workable. The Treasury would be forced to attempt to draw lines which would rule one type of marketing expense "advertising" and another not. Is a free copy of a newspaper an advertising or a production expense? Is the salary of the marketing director to be divided by some formula between advertising and non-advertising? Unworkable concepts create complexity, high compliance costs, and disrespect for the tax system. When the tax law makes distinctions that are not economically real, confusion follows.

STATEMENT OF GERALD Z. GIBIAN, CORPORATE VICE PRESIDENT, TAX AND REAL ESTATE, ESTEE LAUDER CO., MELVILE, N.Y., ON BEHALF OF COMMITTEE FOR COMPETITION THROUGH ADVERTISING

Mr. GIBIAN. Thank you very much. I am Gerald Gibian, corporate vice president, tax and real estate, of the Estee Lauder Cos. Estee Lauder is a member of the Committee for Competition Through Advertising.

On behalf of the committee, I appreciate the opportunity to testify before you today in opposition to a proposal to capitalize advertising costs and amortize them over a period of years.

The Committee for Competition Through Advertising is made up of companies in various industries associated with advertising, including the companies that must advertise their products in order to compete in the domestic and international marketplaces, the companies that assist them in communicating their message, and the companies that provide the media for carrying that message.

Raising consumer awareness of our products and providing information about the prices and features of our products are an integral part of our efforts to compete in the global marketplace and to continue to make certain that U.S. companies remain preeminent.

It is obviously not in the interest of businesses that must advertise to establish and expand the markets for their products and services to be subject to a tax penalty for costs related to selling their products and services. Nor is it in the interest of these businesses that provide the media for advertising, including television and radio stations, newspapers, magazines, publishers of yellow pages and sports franchisers. It is also not in the interest of firms that provide support services for advertising. However, what we wish to focus on today are the numerous reasons that it is not in the interest of the general public to impose this new tax burden.

The increased cost of advertising as a result of this proposal would present a barrier to market expansion for producers of goods and services. Companies that will be hardest hit by the increased cost will be both startup ventures and established businesses that must continually introduce new products. In both cases, more advertising is needed to make the products' existence and attributes known to potential customers.

Creating barriers for new products entering the marketplace will also result in less product innovation, causing the United States to lose global competitiveness. In addition, U.S. producers of goods and services will be at a competitive disadvantage vis-a-vis goods and services produced by foreign-owned companies, because virtually all of our trading partners permit a tax deduction for advertising.

Finally, this proposal will have a particularly devastating effect on small businesses which rely heavily on advertising for short-term business growth.

In summary, the proposal to require the amortization of advertising expenses does not have a sound policy basis. It is bad tax policy. It is bad economic policy. It does not make business sense. To make this clear, there are some points I would like to highlight:

First is the mismatching of income and expense. Under current law, advertising costs are subject to the same principles as other business expenses for determining whether they should be deducted in the year incurred. The Tax Code does not provide special treatment of advertising. Recurring expenditures are generally found to be currently deductible because the need to renew the benefits through additional expenditures each year suggests a useful life of less than a year.

The reasoning behind the argument for requiring amortization of advertising is abstract. A conceptual argument is made that advertising is like capital spending on equipment and structures. There is little evidence to substantiate such a claim. If anything, economic studies show that the value of most advertising is entirely eliminated within 1 year.

However, I can tell you for more than 20 years in the consumer products industry, which is heavily reliant on advertising, that a large proportion of all advertising refers to offers of short duration.

For example, in the cosmetic industry much of our advertising is seasonal, focused on holidays. Similarly, retail advertising is directed at the sale of goods directly to consumers within a short period of time. Also, weekly newspaper ads by a local supermarket announcing the price of lettuce have little value next month, much less next year.

Classified advertising is similar. In addition, promotion advertising is designed to provide an incentive for immediate sales, and in point of fact most coupons have an expiring date of less than 1 year.

Direct marketing through mail or telephone sales is also designed to generate immediate sales. Industries suffering from financial problems advertise for quick sales.

Finally, advertising affects decay quickly. Even well-known brands that stop advertising experience a rapid decline in sales.

Nevertheless, a proposal requiring amortization of advertising expenses would not allow a complete writeoff of expenditures until years after such expenditures rendered any value to the business. This is pure mismeasurement of income, and a pure tax penalty.

In addition, complexity would be increased. There would be reduced competition. There would be a distortion of business practices, and revenue would not be significantly enhanced.

In conclusion, there is no policy justification for further limiting the deductibility of advertising beyond the limitations set by present law. Enactment of any proposal would create a barrier to expansion of markets for goods and services, thereby impeding economic growth at a point in time when economic growth is desperately needed.

In addition, such a proposal would reduce competition by restricting information flow and impeding the ability of new entrants to challenge established firms. It would also add substantial complexity to current tax rules.

Thank you for affording me the opportunity to testify.

Mr. KOPETSKI. Thank you very much, Mr. Gibian.

[The prepared statement follows:]

STATEMENT
on
CAPITALIZATION OF ADVERTISING EXPENSES
scheduled for hearings on
September 8, 1993
before the
SUBCOMMITTEE ON SELECT REVENUE MEASURES
of the
HOUSE COMMITTEE ON WAYS AND MEANS
as part of their hearings on
MISCELLANEOUS REVENUE ISSUES
on behalf of the
Committee for Competition Through Advertising
by
Gerald Z. Gibian, Estee Lauder Companies

I am Gerald Z. Gibian, Corporate Vice President Tax and Real Estate, Estee Lauder Companies. Estee Lauder is a member of the Committee for Competition through Advertising, which represents a coalition of companies in various industries associated with advertising, including the companies that must advertise their products in order to compete in the domestic and international marketplaces, the companies that assist them in communicating their message, and the companies that provide the media for carrying that message. Raising consumer awareness of our products and providing information about the prices and features of our products are an integral part of our efforts to compete in the global marketplace and continue to make certain that U.S. companies remain pre-eminent.

On behalf of the Committee for Competition through Advertising, which includes Estee Lauder Companies; J. Walter Thompson; Ogilvy and Mather; the Omnicom Group, which includes the BBDO, DDB Needham, and TWBA advertising networks; Hachette Filipacchi Magazines, Inc., the publishers of *American Photo, Audio, Boating, Car and Driver, Cycle World, Flying, Popular Photography, Road and Track, Showboats International, Stereo Review, Woman's Day, Elle, Elle Decor, Home Magazine, Best Selling Home Plans, Metropolitan Home;*and Euro RSCG Holdings, Inc, Messner Vetere Berger McNamee Schmetterer, Tatham, Stranger & Associates, Creamer Dickon Basford, Lally McFarland & Pantello, Robert A. Becker, I would like to thank you for the opportunity to express our views on a proposal that would replace immediate write-offs of advertising expenses with amortization of these expenses over a fixed number of years.

It is obviously not in the interest of businesses that must advertise to establish and expand the markets for their products and services to be subject to a tax penalty -- which is what this proposal amounts to -- for costs related to selling their products and services. Nor is it in the interests of those businesses which provide the media for advertising, including television stations, radio stations, newspapers, magazines, publishers of "yellow pages," and sports franchises. It is also not in the interest of firms that provide the support services for advertising firms. However, what we wish to focus on today are the numerous reasons that it is not in the interest **of the general public** to impose this new tax burden.

The increased cost of advertising as a result of this proposal would present a barrier to market expansion for producers of goods and services, which could result in lower overall economic growth. Companies that will be hardest hit by the increased cost will be both start-up ventures, already strapped for cash, and established businesses that must continually introduce new products. In both cases, more advertising is needed to make the products existence and attributes known to potential customers. Creating barriers for new products entering the marketplace will also result in less product innovation, causing the U.S. to lose global competitiveness. In addition, U.S.-owned producers of goods and services will be at a competitive disadvantage vis-à-vis goods and services produced by foreign-owned companies because virtually all of our trading partners permit a deduction for advertising. Finally, this proposal will have a particularly devastating effect on small businesses, which rely heavily on advertising for short-term business growth.

Increasing the cost of advertising would also affect publishers and broadcasters and the wide public access to news and information, as well as commercial television and radio programming, that they currently can provide to the public at little or no charge because they are supported by advertising. Increased costs of advertising will result in less advertising revenue for the media and likely will be felt more in smaller communities. Publishers and broadcasters that are suffering financially may not be able to withstand the drop in advertising revenue.

In summary, the proposal to require the amortization of advertising expenses does not have a sound policy basis. It is bad tax policy. It is bad economic policy. It does not make business sense. To make this clear, there are five additional points I would like to highlight:

1. In general, the anticipated effect of advertising is to increase sales in the immediate future. Thus, capitalizing a portion of advertising expenses would create a mismatching of income and expense that penalizes companies that advertise to increase sales of their products.
2. Devising and implementing a definition of "advertising" for tax purposes would be extremely difficult and would add a great deal of complexity to the tax law.
3. Increases in the after-tax cost of advertising reduce competition.
4. Requiring amortization of advertising expenses would result in the needless distortion of business practices.
5. Behavioral responses to a requirement to capitalize advertising would eliminate a significant portion of the anticipated revenue gain.

Mismatching Income and Expense

Under current law, advertising costs are subject to the same principles as other business expenses for determining whether they should be deducted in the year incurred, as so-called "period costs," or whether they should be capitalized and amortized over a period of years. The tax code does not provide special treatment of advertising. Recurring expenditures are generally found to be currently deductible because the need to renew the benefits through additional expenditures each year suggests a useful life of less than a year. Colorado Springs National Bank v. U.S.,.505 F.2d 1185, 1192(10th Cir. 1974). The reason for currently deducting most normal recurring advertising has been stated as follows:

> "The reason advertising expenses are (currently expensed) is that these expenses are generally of a yearly recurring nature resulting from a regular activity of a taxpayer which produces new business on a relatively consistent basis each year." Manhattan Co. of Virginia, Inc., 50 T.C. at 86 (1968).

The reasoning behind the argument for requiring amortization of advertising is abstract: a conceptual argument is made that advertising is like capital spending on equipment and structures. However, although this is a theoretically intriguing argument, there is little evidence to substantiate such a claim. If anything, economic studies show that the value of most advertising is entirely eliminated within one year. A recent study[1] partially co-authored by two Nobel Laureates in economics, Dr. Kenneth J. Arrow and Dr. George G. Stigler, concludes:

> [A]lthough there are a number of economic studies that suggest that advertising is long-lived, they are generally so fraught with errors that one cannot rely on their findings. When we correct for some statistical problems, we find that

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[1] Kenneth J. Arrow, George G. Stigler, Elisabeth M. Landes, and Andrew M. Rosenfeld, Economic Analysis of Proposed Changes in Tax Treatment of Advertising Expenditures, Lexicon, Inc., Chicago, April 1990.

> the estimated duration intervals are much shorter than originally thought. Moreover, there are a number of studies (particularly more recent ones) that suggest that advertising depreciates so rapidly that virtually all of its effects are gone within a year. In short, the economic evidence does not support the view that advertising is long-lived.[2]

For those that do not trust economists--even those with Nobel prizes--it is important to check their claims against a little common sense. Obviously, a large proportion of all advertising refers to offers of short duration. Retail advertising is directed at the sale of goods directly to consumers within a short period of time. For example, weekly newspaper ads by a local supermarket announcing the price of lettuce have little value next month, much less next year. Classified advertising is similar. In addition, promotion advertising (e.g. where cents-off, refunds, premiums, or coupons are offered) is designed to provide an incentive for immediate sales and, in point of fact, most coupons have an expiration date of less than one year. Direct marketing, through mail or telephone sales, is also designed to generate immediate sales. Industries suffering from financial problems advertise for quick sales. Seasonal products are advertised for short periods during the year with the objective of selling as much as possible during that time. In addition, a large portion of new product advertising clearly has little value after one year because the products themselves often do not exist after one year. Furthermore, the Federal Trade Commission regulates the length of time that certain advertisements can run. An advertiser cannot describe a product as "new" for a period of time longer than six months. See Advisory Opinion Digest, No. 120, April 15, 1967; Advisory Opinion Digest, No. 146, October 24, 1967. Finally, advertising's effects "decay" quickly -- even well-known brands that stop advertising experience a rapid decline in sales. Nevertheless, a proposal requiring amortization of advertising expenses would not allow a complete write-off of expenditures until years after such expenditures rendered any value to the business. This is pure mismeasurement of income, and a pure tax penalty to businesses simply trying to promote their products.

Of course, we can all imagine instances when advertising does have a useful life in excess of one year. However, there is no need to change the law to achieve the proper tax treatment in these cases. Under present law, there are already established criteria for determining whether advertising, like any other business expense, should be capitalized and amortized over a number of years.[3]

Complexity

Any proposals that require amortization of expenses would add a new layer of mind-numbing complexity to the tax law. A description of legislation to implement this proposal could be deceptively simple, but the Treasury regulations interpreting this rule will be extremely complicated and will be followed by years of controversies between taxpayers and the IRS over which costs are non-deductible advertising expenses and which may be considered to be some other deductible business expense.

The term "advertising" is just one component of general marketing expenses incurred by business. Advertising, promotion, and marketing expense can take many forms. Product demonstrations, trade shows, free samples, price discounts, phone solicitations, mail solicitations (including mail order catalogs), on-site solicitation, public relations, and community service are all methods that businesses use to promote themselves and their products. It is unclear which of these are "advertising" under the proposal and which are not.

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[2] Id. at 39-40.

[3] See, e.g., Welch v. Helvering, 290 U.S. 11 (1933) (payments to promote development of business and to establish goodwill of prospective customers); Cleveland Electric Illuminating Co. v. U.S., 7 Cl. Ct. 220 (1985) (advertising expenditures intended to lessen public fears about a nuclear power plant); Best Lock Corp. v. Comm'r., 31 T.C. 1217, 1234-5 (1959) (expenditures to produce trade catalogues); Rev. Proc. 89-16, 1989-1 C.B. 822 (package design costs); Rev. Rul. 68-283, 1968-2 C.B. 63 (advertising to promote products at state fair operated over two tax years).

The end result would be tremendous uncertainty for taxpayers that are acting in good faith and trying to comply with the law. It is important to remember that advertising expenditures are undertaken by hundreds of thousands of corporations, partnerships, and sole proprietorships of all sizes. Their uncertainty would not be reduced after the publication of dozens of pages of regulations (probably three to five years after passage of the initial statute). Even scarier is the specter of hundreds and perhaps thousands of accountants and attorneys who would be hired by private business to defend us against the onslaught of controversy with IRS. On the government side, a legion of IRS agents would have to be trained in the intricacies of this new law. Steep compliance costs for business as well as large administrative costs for the Federal government need to included in your consideration of any proposal to require amortization of advertising. Although they do not appear in any official revenue estimate, these costs are very real.

Reduced Competition

As any economist will tell you--whether it is the stock market or the supermarket--it is information that makes markets function efficiently. Advertising provides essential information to consumers and businesses and thereby promotes competition.[4] When a business advertises price and quality, it forces competitors to lower prices and increase quality.

Furthermore, the consumer benefits from advertising are not only information about the specific product of the company sponsoring the advertising but are often also general information about that product which may be sold by a number of companies. This "spillover" benefit of advertising is especially large for new products and more complex products. In such cases, there is concern that there is too little advertising and the last thing that should be done is penalize such advertising. For example, consider the introduction of a new type of low-fat shortening used in a wide variety of food products. It certainly may be a benefit for society as a whole to be better informed about a product that can improve public health, but it does not pay for any one firm to do this advertising. Therefore, less advertising is undertaken than is socially optimal.

Finally, advertising is the great equalizer. By means of advertising, new entrants with lower-cost or higher-quality products can enter into a market and may take on existing dominant firms. By breaking down "barriers to entry," advertising greatly increases the competition within an industry and the overall competitiveness of the economy. Increasing the cost of advertising will disproportionately hurt start-up businesses and businesses with new products that are more dependent on advertising. In addition, the increased cost will be particularly harmful to marginal businesses that depend on advertising to create a quick boost in sales. Small business, in particular, will be hurt by this proposal because they are very dependent on advertising for short-term sales to create the cash to build their business.

Not only would the capitalization of advertising result in reduced competition in the marketplace, but also it would put U.S. producers of goods and services at a competitive disadvantage vis-à-vis foreign-owned companies selling goods in the United States. Virtually all of our trading partners provide a deduction for advertising. Therefore, for U.S.-owned firms the cost of advertising their products will be higher than it is for foreign-owned firms.

Distortion of Business Practices

If, as proposed, the current deductibility of advertising were limited, businesses likely would shift their marketing activities from those falling under the new tax definition of "advertising" to other similar activities. For example, in response to this new tax penalty, a business might reduce spending on "conventional" advertising and instead increase the size of its sales force or increase its direct mail solicitation even though these methods may not be the most effective means of promoting its product. Thus, purely in response to a change in the tax law, resources would be diverted from their most efficient uses.

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[4] See, for example, Benham, "The Effect of Advertising on the Price Of Eyeglass, " Journal of Law and Economics, Vol., 15 (1972), p.337.

Those businesses that rely heavily on tax-disadvantaged advertising would be at a competitive disadvantage. For example, a clothing retailer that relies on conventional print advertising would be put at a competitive disadvantage with a clothing mail-order cataloger who relies entirely upon mailing to market its product.

Similarly, those businesses that rely heavily on providing tax-disadvantaged advertising would be at competitive disadvantage. For example, television stations and newspapers would suffer at the expenses of firms that perform promotions and phone solicitation.

Revenue

This Subcommittee is currently considering a proposal to capitalize and amortize a portion of advertising expenses in order to raise revenue. However, behavioral responses to the proposal will eliminate a significant portion of the anticipated revenue gain as businesses seek other means to market their goods and services. However, even if a relatively small amount of revenue were collected, the overall burden on the users and providers of advertising would still be large.

Conclusion

There is no policy justification for further limiting the deductibility of advertising beyond the limitations set by present law. Enactment of any such proposal would create a barrier to expansion of markets for goods and services, thereby impeding economic growth at a point in time when economic growth is desperately needed. In addition, such a proposal would reduce competition by restricting information flow and impeding the ability of new entrants to challenge established firms. It would also add substantial complexity to current tax rules.

Mr. KOPETSKI. Our next witness is Mark McConaghy, former Chief of Staff of the Joint Committee on Taxation, presently the Managing Partner of the Washington National Tax Services, Price Waterhouse Corp. here in Washington, D.C. Welcome back to this committee.

STATEMENT OF MARK MCCONAGHY, MANAGING PARTNER, WASHINGTON NATIONAL TAX SERVICES, PRICE WATERHOUSE, WASHINGTON, D.C., ON BEHALF OF AD HOC GROUP TO PRESERVE DEDUCTION FOR ADVERTISING

Mr. MCCONAGHY. Thank you, Mr. Chairman. I appreciate the opportunity to appear before the subcommittee today to discuss the tax policy issues relating to advertising expenses. I am testifying today on behalf of a coalition of companies with a common goal of retaining the current tax treatment of advertising expenses.

As you know, before the subcommittee is a proposal to limit the current business deduction for advertising expenses as a part of a number of revenue-raising proposals. Such proposals are not new. They have been considered in the past by the Ways and Means Committee and the Senate Finance Committee. For a number of good reasons, Congress has declined to make changes in this area of the tax law.

I would like to focus today on several issues relating to the tax treatment of advertising expenses that demonstrate why Congress should continue to permit the current deduction. These issues are the status of the law and policy issues relating to the treatment of current versus capital expenditures, the financial statement treatment of advertising expenses, and, finally, the administrative complexity that would be added to the tax law if such proposals were enacted.

Advertising is an ordinary necessary business expense permitted as a deduction under section 162 of the Internal Revenue Code.

The allowance of that deduction reflects the net income concept underlying the U.S. income tax system. Under a net income concept, all expenditures that are not contrary to public policy should be recognized either as a current deduction or a future deduction through depreciation or amortization. To determine when the expenditure is recognized, one must satisfy two concerns; that the expenditure be recognized at approximately the same time as the revenue to which it relates is recognized and that the items only be recognized when they can be measured with reasonable certainty. Generally an expenditure should be allowed as a deduction unless it creates some measurable future benefit.

The fact is that most advertising expenses are associated with current income. For example, advertising is used to notify consumers of current prices, provide information about new models, provide industrial customers with product specifications, and direct consumers to retailers who stock the product. To limit the current deduction of the cost of a real estate listing or a supermarket advertisement in today's newspaper on the grounds that some portion of the advertising may be related to a future year's income is just not fair.

To go down the road suggested by the proposal before the subcommittee today would suggest that a portion of all of our salaries should be capitalized to reflect the fact that every working experience we encounter in our jobs will train us for future workplace experiences. Similarly, such an argument might require capitalization for expenditures relating to the preparation of a corporation's financial statement, a portion of a marketing director's salary or the costs associated with a corporate strategic planning department since these expenditures may produce some future benefit to the corporation.

To single out advertising costs from other period costs that are currently deductible does not represent sound tax policy. Moreover, any lines that are drawn between advertising costs and other corporate expenditures will give an advantage to certain approaches to marketing as compared to others. It is for these reasons that the financial accounting principles have required that advertising be deducted currently and have allowed the capitalization of advertising expenses only in very limited circumstances.

This position has recently been reviewed and affirmed by the financial accountants in the AICPA and accepted and cleared for final issuance by the Financial Standards Accounting Board.

The AICPA concluded that capitalizing advertising expenses generally should not be permitted due to the difficulty in identifying and isolating future benefits that arise from those expenditures. While the tax and financial statement treatment of an expense do not necessarily have to be the same, in the case of advertising a common issue drives both tax and accounting treatment. It is simply too difficult to identify and measure the asset that is produced when expenditures are made on advertising.

Current tax law already addresses instances where the future benefit of advertising expenses extend significantly beyond the period in which the expenditures are incurred. In such cases, advertising expenses are capitalized.

Finally, distinguishing those advertising expenses for which a deduction would not currently be allowed would create administrative nightmares for both the IRS and taxpayers. Even if Congress were to limit the current deductibility to an arbitrary percentage, the IRS and taxpayers would still be thrown into endless controversies over resolving which marketing and other expenditures would continue to be deducted currently.

What would be the treatment, for example, of product inventory discounts, or giveaway promotions that are utilized to launch a product? What about the sponsorship of public events, the preparation of point of sale materials such as brochures, or something as simple and basic as printing business cards? The list goes on and on and the definitional issues would be tremendous.

Any limitation on the deductibility of advertising expenses would require that rules and tests be established for all these activities and expenditures which are generally deductible under present law. It would be extremely difficult for the IRS to write and administer any rules that distinguish between these costs.

In summary, I would like to thank the subcommittee for permitting me the opportunity to testify on this issue today. Furthermore, I would like to urge the subcommittee to continue to heed the principles of tax reform and simplification as it considers revenue-raising proposals. Proposals requiring a portion of advertising costs to be capitalized run counter to those principles by needlessly complicating the tax law and wasting precious Government and taxpayer resources on litigation and record keeping.

Mr. Chairman, I would like permission to submit a written statement for the hearing record and would be pleased to answer questions.

Mr. PAYNE [presiding]. Without objection, so ordered, and thank you for your testimony.

[The prepared statement follows:]

STATEMENT OF MARK McCONAGHY
AD HOC GROUP TO PRESERVE THE DEDUCTION FOR ADVERTISING

I. SUMMARY

My name is Mark McConaghy and I am the managing partner of Price Waterhouse's Washington National Tax Services office. I appreciate the opportunity to appear before the subcommittee today to discuss the tax and financial accounting issues relating to advertising expenses.

I am testifying today on behalf of a coalition of companies and trade associations with the common goal of retaining the current tax treatment of advertising expenses. A list of the members of the coalition is included at the end of this testimony.

As you know, before the subcommittee is a proposal to limit the current business deduction for advertising expenses as one of a number of miscellaneous revenue-raising proposals. Such proposals are not new; they have been considered in the past by both the House Ways and Means Committee and the Senate Finance Committee.

For a number of sound reasons, Congress has declined to make changes in this area of the tax law. I would like to focus today on several issues relating to the tax treatment of advertising expenses that demonstrate why Congress should continue to permit the current deduction. These are as follows:

- The policy issues relating to the treatment of current versus capital expenditures.
- The financial accounting treatment of advertising expenses.
- The administrative complexity that would be added to the tax law if such proposals were enacted.

II. BACKGROUND AND TAX POLICY ISSUES

Matching and Measurability

Advertising is an ordinary and necessary business expense permitted as a deduction under Internal Revenue Code Section 162(a). The allowance of the deduction reflects the net income concept underlying the U.S. income tax system.

Under a net income concept, all ordinary and necessary business expenditures (not contrary to public policy) should be recognized either as a current deduction or as a future deduction, through depreciation or amortization. To determine when the expenditure is recognized, one must satisfy two tax policy concerns that permeate our income tax system -- the need to match deductions and income, and the practical requirement that items of income and expense be recognized when they can be accurately measured.

The matching of income and expenditures results in a more accurate calculation of net income. Thus, expenditures generally are required to be capitalized -- and amortized and deducted over a period -- if they produce significant income over a period that is longer than one year. The accurate calculation of net income also requires that items be recognized when they can accurately be measured. Requiring an expenditure to be capitalized where the future benefit to be derived from the expenditure is merely speculative does not accurately measure income. Generally, an expenditure is and should be allowed as a current deduction unless it creates a measurable future benefit.

The fact is that advertising expenses are associated with current income. For example, advertisements are used to notify consumers of current prices, provide information about new models, provide industrial customers with product specification, and direct consumers to retailers who stock the product. To limit the current deduction of the cost of a real estate listing or a supermarket's advertisement in today's newspaper on grounds that some portion of the advertising may be related to a future year's income is clearly unfair. It is extremely difficult to identify the benefits of advertising that stretch beyond a relatively short period of time. If it is possible that some future benefit may be derived from advertising, that future benefit is neither demonstrable nor susceptible to measurement.

It is also important to recognize that advertising expenses generally represent a risky investment. No one knows whether a new ad campaign will be successful or how long the effects of advertising will last.

Large corporations that undertake so-called goodwill or institutional advertising to, among other things, improve consumer recognition of the company and its products generally do so on a regular basis. There is little or no expectation that the benefits of this advertising will last for a significant period of time. It is extremely unlikely that a corporation could measure whether institutional advertising produced any increase in sales over the long run. There is no method that exists for identifying and measuring those lasting benefits, if such benefits do in fact exist.

In many respects, advertising expenditures that are longer lasting are similar to outlays for research and development. They may produce income in future years, but the amount and duration of those returns are very uncertain. Congress has continued to reaffirm the current deductibility of research and developmental expenditures. Congress has done so not only as an incentive but also in recognition of the fact that requiring the capitalization of such expenditures would create difficult administrative problems and would not necessarily produce a better measure of net income.

The proposal before the committee to limit the current deduction for a portion of advertising expenditures supposes the use of an arbitrary capitalization rule that is not designed to accurately measure net income. For example, if it were assumed that virtually all companies' advertising provides no future benefit, any average capitalization rate would mismeasure the net income of those companies. The average capitalization rate would also not be correct for the very small percentage of companies whose advertising was presumed to provide a future benefit. Thus, such an approach can never adequately or accurately match income and deductions. It would be inaccurate for virtually all taxpayers.

Comparison with other period costs

Treating a portion of advertising costs as a capitalizable item would set a very disturbing precedent. It would suggest that a portion of any ordinary and necessary business expenditure could be capitalized if it includes a component that produces a speculative future benefit.

In performing our jobs, each of us learns how to perform the job better. Every working experience we encounter in our jobs trains us to handle future work place experiences. Yet few would suggest that an arbitrary portion of each of our wages should be capitalized in order to reflect that potential future benefit to our employers.

Similarly, it could be argued that expenditures relating to the preparation of a corporation's financial statement or the costs associated with a corporate strategic planning department will produce some future benefit to the corporation, and thus should be capitalized. There is also a future benefit in making expenditures to ensure that a company is complying with federal and state regulations. Yet, in none of these cases is capitalization appropriate or desirable because the future benefit is speculative and uncertain.

To single out advertising costs from other period costs that are currently deductible simply does not represent sound tax policy. Moreover, any lines that are drawn between advertising costs and other corporate expenses will give an advantage to certain approaches to marketing as compared to others. For example, retailers that must advertise on a regular, weekly basis in order to bring consumers into their stores would be disadvantaged by the proposal.

Current Tax Law Adequately Addresses Future Benefits

Current tax law already addresses instances where the future benefit of advertising expenditures extends significantly beyond the period in which the expenditures are incurred. In such cases, advertising expenditures are capitalized.

For example, where advertising expenditures are incurred in connection with placing depreciable property in service, the advertising costs must be capitalized into the cost of the property. Thus, in Cleveland Electric Illuminating Co. v. U.S., 7 Cl. Ct. 220 (1985), advertising expenditures made by a utility to ease the public's fear of nuclear power related to the construction of a nuclear power plant were required to be recovered as the plant was depreciated.

Advertising expenditures that result in identifiable tangible assets with useful lives, such as the purchase of a blimp, are currently required to be capitalized for Federal income tax purposes. Expenditures that result in identifiable intangible assets that will be used repeatedly in future advertising campaigns must also be capitalized.

There are other examples where the law clearly provides for the capitalization of large, one-time expenditures associated with the creation of a tangible or intangible asset with a life that extends beyond one year. In each of these situations an asset that could be exploited for future benefit had clearly been brought into existence. On the other hand, the more common types of advertising do not generate such an asset. In the absence of the generation of an asset that will demonstrably contribute to a future income stream, a current deduction is appropriate.

III. FINANCIAL ACCOUNTING ISSUES

The inability to establish and measure the future economic benefit of advertising is the primary reason that financial accounting principles have required almost all advertising to be expensed currently, and has allowed capitalization in only very limited circumstances.

The American Institute of Certified Public Accountants recently approved a Statement of Position (SOP) entitled, "Reporting on Advertising Costs" that was prepared by its Accounting Standards Executive Committee (AcSEC). The SOP was approved and cleared for final issuance by the Financial Accounting Standards Board (FASB) on June 10, 1993. Accordingly, the SOP may be considered an explanation of the application of generally accepted accounting principles.

The SOP requires that the costs of advertising be expensed on a company's financial statements either as incurred or as of the first time the advertising takes place, unless the advertising is direct-response advertising that results in probable future economic benefits or results in the acquisition or creation of a tangible asset with use beyond the current advertising campaign (such as the above-noted blimp).

In preparing the SOP, the AcSEC rejected the notion that advertising costs that are not related to tangible assets -- other than direct-response advertising expenditures -- be capitalized because "future benefits beyond the first time the advertising takes place are too uncertain and are not demonstrable or measurable with the degree of precision required to recognize an asset."

The AcSEC concluded that the ability to identify and isolate future benefits has improved because of greater sophistication of data-gathering and analysis, based on econometric models and scanner studies. However, the AcSEC maintained that most advertising should be expensed and that capitalization of most advertising should be prohibited because the benefits are not measurable "with the degree of precision required to report an item in the financial statements."

The financial accounting and tax treatment of particular business expenditures do not necessarily have to be the same. In fact, the financial accounting treatment of advertising costs should be only one factor taken into account in determining the tax accounting treatment of such costs. However, the theory behind capitalization for both financial and tax accounting principles is the same -- that the period in which expenses are deducted should match the period in which the income generating those expenses was earned. In general, for both tax and financial accounting purposes, advertising costs match income earned in the current year.

Direct Response Advertising

The AcSEC determined that the only exception to the concept that advertising be expensed for financial accounting purposes should be in the case of direct-response advertising. Direct-response advertising is advertising that is expected to result in a decision to buy an entity's products or services by customers who can be shown to have responded specifically to the advertising. In order to sustain such a showing, documentation demonstrating the customer has responded to a specific advertisement is required. Where capitalization of direct-response advertising is allowed by the SOP, it is expected that the period over which the benefits of direct-response advertising are amortized would usually be short.

IV. ISSUES OF ADMINISTERABILITY AND COMPLEXITY

Distinguishing those advertising expenditures for which a deduction would not be currently allowed would create administrative nightmares for both the IRS and taxpayers. Even if Congress were to limit the current deductibility to an arbitrary percentage, the IRS and taxpayers would still be thrown into endless controversies over resolving which marketing and other expenditures would continue to be deductible currently.

Direct payments to the media for placing advertisements may more easily fall within a simplified definition of advertising. However, the line between direct advertising expenditures and other product marketing costs is very difficult to draw. What would be the treatment, for example of product introductory discounts, or even giveaway promotions that are utilized to launch a product? What about the sponsorship of public events, the preparation of point-of-sale materials, such as brochures, or something as simple and basic as printing business cards? The list goes on and on.

Such a proposal would require additional recordkeeping to capture costs for a category of business expense arbitrarily carved out from other ordinary and necessary business costs. Taxpayers probably would be required to maintain records of their advertising and other marketing expenses for lengthy periods. Moreover, the discrepancy between financial and tax accounting that would be created under the proposal would require taxpayers to create new reconciliations of these differences to be accounted for on Form 1120. While businesses identify "advertising costs" on their tax returns now, most businesses do not undertake the recordkeeping necessary to distinguish advertising from promotional costs, or to allocate payroll to reflect time an employee may spend in reviewing an advertising campaign, for example.

Any limitation on the deductibility of advertising expenditures would require that rules and tests be established for all these activities, the expenditures for which generally are deductible under current law. It would be extremely difficult for the IRS to write and administer any rules that distinguish between these costs.

V. REVENUE CONSIDERATIONS

A principal reason for proposals to limit the current deduction for advertising have traditionally been the revenue that such proposals would generate. It is not sound tax policy to adopt rules that result in the mismeasurement of net income solely to raise revenue.

It should also be noted that a proposal to require capitalization and amortization of some or all advertising expenditures is a timing issue, not an issue of reducing total deductions permitted to the taxpayer. Deferral of advertising deductions could increase revenue initially through a substantial one-time effect, but would otherwise raise only modest additional revenue in later years. Thus, any five-year revenue estimate would greatly overstate the long-run revenue effect of such proposals.

VI. CONCLUSION

Congress in general, and this subcommittee in particular, should reject any proposal to capitalize a portion of advertising expenses. Such a proposal would result in less accurate measurement of net income, would deviate from well-established principles of financial accounting, and would create new and unnecessary compliance burdens for taxpayers as well as increase the administrative burden on the IRS. While such a proposal would raise some "one-time" revenue, it would do so at the cost of permanent inaccuracies in the measurement of net income and permanent inefficiencies in the administration of the tax system.

Ad Hoc Group to Preserve the Deduction for Advertising

Borden, Inc.

Campbell Soup Company

E.I. Du Pont De Nemours and Company

Eastman Kodak Company

General Mills, Inc.

General Motors Corporation

Goodyear Tire & Rubber Company

Hallmark Cards, Inc.

Hasbro, Inc.

Hewlett-Packard Company

Kellogg Company

Merck & Co., Inc.

NATIONAL ASSOCIATION OF REALTORS®

NIKE, Inc.

NYNEX Corporation

Owens-Corning

PepsiCo, Inc.

Pillsbury

Sara Lee Corporation

Mr. PAYNE. Our last witness of this panel represents the Advertising Tax Coalition, Timothy White, who is a publisher of Times Union, Albany, N.Y.; and my good friend DeWitt Helm, the president of the Association of National Advertisers, New York, N.Y. DeWitt and I were business colleagues in Virginia. We never thought at that time we would be seeing each other in this setting. Welcome to the Ways and Means Committee.

STATEMENT OF TIMOTHY WHITE, PUBLISHER, TIMES UNION, ALBANY, N.Y., ON BEHALF OF THE ADVERTISING TAX COALITION AND THE NEWSPAPER ASSOCIATION OF AMERICA

Mr. WHITE. Thank you for the introduction. In addition to being publisher of the Times Union, a daily newspaper with a circulation of 103,000 daily and a Sunday edition of 160,000, additionally I appear on behalf of the Newspaper Association of America and the Advertising Tax Coalition.

The Newspaper Association of America represents approximately 1,250 newspapers in the United States and Canada. The majority are newspapers that account for more than 80 percent of the total daily circulation in the United States.

The Advertising Tax Coalition consists of 10 national trade associations of which the newspaper association is one member.

As our country struggles to emerge from this recession, the last thing we need or anyone needs is a reason not to advertise. Public policy should be encouraging manufacturers, retailers and service providers to reach out to new customers through advertising in an effort to break this recession and to get the economy growing again. A tax on advertising would have the opposite effect.

The present law treatment of advertising costs represents sound tax policy. It reflects the reality that the cost of advertising is just as essential to the operation of a business as the salaries of its employees, the rent for its space or the gasoline for the cars used by the sales staff.

It is impossible to distinguish between advertising and all other marketing expenses or promotion and sales expenses. Limiting advertising expense deductibility would mean that sales staff meetings to discuss new sales techniques would be fully deductible, but not meetings to review the latest ad campaign.

Another reason to currently deduct the cost of advertising is that it is an expense that must be repeated or even increased from year to year, reflecting the fact that advertising does not stay around to create ongoing sales. Buying advertising does not buy an asset for a company. The overwhelming volume of newspaper advertising is designed to alert the reader to the availability of a certain product or service at a certain price under certain conditions and most often at a specific time and location.

Take a look at this copy of last Sunday's edition of the Times Union. We have some advertising on the back page of the A section by Olender Furniture and Sleep Shop, a local enterprise promoting a 12-hour Labor Day sale. Just inside we have a Filene's Labor Day clearance sale, and on page 2 an optician promoting free eye exams to returning students.

Where is the residual asset value for the retailers whose lifeblood is promoting tomorrow's special offer on a gallon of milk, a Mercury

Marquis or back to school overalls? Most consumer businesses, especially retailers, have two things in common. First, they already operate on razor thin profit margins and, second, advertising expense represents a significant portion of their total operating costs.

Reduce the deductibility of those advertising expenses and you unfairly pressure an already stressed sector of our private economy. Two Nobel laureates in economics, the late George Stigler and Dr. Kenneth Arrow, wrote a paper for the Advertising Tax Coalition stating that "Advertising is a powerful tool of competition. It provides valuable information about products and services in an efficient and cost-effective manner. In this way advertising helps the economy to function smoothly, it keeps prices low and facilitates the entry of new products and new firms into the marketplace."

The ads in this edition of the Times Union offer our readers a potpourri of choices between vegetables and cuts of meat at competing grocery stores, new automobiles at various Albany dealerships, or new jobs with employers competing for a variety of employee skills. Without advertising, consumers would have to search on their own for information about the existence and identity of sellers and the prices they charge.

Certainly no one has to explain to a newspaper publisher how dramatically advertising fosters competition. During the past 30 years our country has witnessed a virtual explosion of alternative information sources in every community in the United States. In the 14-county Albany area alone, for instance, there are 11 other daily newspapers, four local network affiliated TV stations, 20 network affiliated radio stations, 16 independent radio stations, a cable advertising network with three franchises reaching 142,000 homes, 6 outdoor billboard advertising companies, and more than 48 weekly community newspapers and shoppers. These 100+ media companies together with direct mail and yellow pages advertising compete for the annual $330 million spent in this relatively small marketplace alone.

Since more than 80 percent of the ad dollars spent in this marketplace are spent with competitors of the Times Union, I am reminded daily of the role advertising plays in stimulating diversity and competition in American media.

In conclusion, I cannot conceive of a tax proposal that more violates our American concept of fair play or a level playing field than does the proposal to limit the current deduction for advertising expenses, nor can I think of a tax proposal that is more counterproductive at a time when we are attempting to stimulate our national and local economies.

Mr. Chairman, this subcommittee has a challenging task to meet the revenue needs of this country, and I appreciate the difficulty of your job. Nevertheless, we believe that the proposal to limit the deductions for advertising costs would be unfair and anticompetitive and would only contribute to slow growth or no growth in our economy. We strongly urge you to reject this proposal. Thank you.

[The prepared statement follows:]

STATEMENT BY TIM WHITE
ON BEHALF OF
THE NEWSPAPER ASSOCIATION OF AMERICA
AND
THE ADVERTISING TAX COALITION
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, D. C.

SEPTEMBER 8, 1993

Mr. Chairman, and Members of the Subcommittee, my name is Tim White, and I am publisher of the *Times Union* of Albany, New York, a daily newspaper with a circulation of 106,000, and a Sunday edition circulation of 160,000. I am appearing today on behalf of the Newspaper Association of America (NAA) and the Advertising Tax Coalition, of which NAA is a member.

The Newspaper Association of America is a non-profit trade association representing approximately 1,250 newspapers. NAA members account for more than 80 percent of U.S. daily and Sunday newspaper circulation. Many non-daily newspapers also are members of NAA.

The Advertising Tax Coalition consists of ten national trade associations, including NAA. The other members of the Advertising Tax Coalition include: American Advertising Federation, the American Association of Advertising Agencies, the Association of National Advertisers, the Direct Marketing Associatio the Grocery Manufacturers of America, the Magazine Publishers of America, the National Association of Broadcasters, the National Newspaper Association, and th Yellow Pages Publisher's Association.

As our country struggles to emerge from this recession, the last thing we need, or anyone needs, is a reason not to advertise. Public policy should be encouraging manufacturers, retailers, and service providers to reach out to new customers through advertising, in an effort to break this recession, and to get the economy growing again. A tax on advertising would have the opposite effect:

First, the present law treatment of advertising costs represents sound tax policy. It reflects the reality that the cost of advertising is indistinguishable from any other marketing cost, whether for direct promotion, point of sales promotion, discount promotions, or the salaries of sales personnel. The cost of advertising is just as essential to the operation of a business as the salaries of its employees, the rent for its space, or the gasoline for the sales staff's cars.

Second, it is impossible to distinguish between advertising and all other marketing expenses, or promotion and sales expenses. Sales staff meetings to discuss new sales techniques would be fully deductible, but not meetings to review the latest ad campaign.

Third, another reason to currently deduct the cost of advertising is that it represents a period cost -- the amount spent on it must be repeated or increased from year to year, which reflects the fact that advertising does not stay around to create ongoing sales. Buying advertising does not buy an asset for a company. Th overwhelming volume of newspaper advertising is designed to alert the reader to the availability of a certain product or service, at a certain price, under certain conditions, and often at a specific location. It would not take a *Times Union* reade long to reach that conclusion without the benefit of economic research. Just take a look at this copy of last Sunday's edition of the *Times Union* -- we have advertising for Olender Furniture and Sleep Shop ("91 Years of Good Family Business"), promoting a 12-hour Labor Day Sale. We have Filene's Labor Day Clearance Sale, and on Page A2 we have an ad for a local optician offering returning students free eye exams.

Where is the residual asset value for the thousands (no, millions) of retailer whose life-blood is promoting tomorrow's special offer on a gallon of milk, a Mercu Marquis, or back-to-school overalls? Most consumer businesses -- and especially retailers -- have two things in common: (1) They already operate on razor-thin profit margins, and (2) Advertising expense represents a significant portion of thei total operating costs. Reduce the deductibility of those advertising expenses and you unfairly pressure an already-stressed sector of our private economy.

Two Nobel Laureates in economics, the late Dr. George Stigler and Dr. Kenneth Arrow, wrote a paper for the Advertising Tax Coalition which states that "advertising is a powerful tool of competition . . . It provides valuable information about products and services in an efficient and cost effective manner. In this way, advertising helps the economy to function smoothly -- it keeps prices low, and facilitates the entry of new products and new firms into the market." The ads in this edition of the *Times Union* offer our readers a potpourri of choices between vegetables and cuts of meat at competing grocery stores, new automobiles at vario Albany dealerships, or new jobs with employers competing for a variety of employe skills. Without advertising, consumers would have to search on their own for information about the existence and identity of sellers, and the prices they charge.

As any daily newspaper, magazine, broadcast station, or other advertising-supported form of media will demonstrate, advertising makes it possible for reader and viewers to have access to a range of information and entertainment at little or no cost, which makes the marketing and entertainment segments of our economy the model for the world.

No one has to explain to a newspaper publisher how dramatically advertisin fosters competition. During the past 30 years our country has witnessed an explosion of alternative information sources in every community in the United States. Recently, my local phone company suggested that the *Times Union* was a non-competitive monopoly in the Albany market.

Let me describe how absurd it feels to be described by my NYNEX colleague as monopolistic. Markets are defined today by the television industry -- they are called Areas of Dominant Influence (ADI's). In the 14-County Albany ADI there a 11 other daily newspapers, four local network-affiliated TV stations, 20 network-affiliated radio stations, 16 independent radio stations, a cable advertising networ representing three franchises and 142,000 homes, six outdoor billboard advertisin companies, and more than 48 weekly community newspapers and shoppers.

These 100-plus media companies, together with direct mail and Yellow Page advertising, compete for the annual $330 million spent in this marketplace. Over 80 percent of the ad dollars spent in this marketplace are spent with competitors o the *Times Union*. In fact, three out of five newspaper readers read something othe than the *Times Union* each weekday, and one-third of those who do read our paper also read something other than the *Times Union* on an average weekday.

Advertising also is indispensable to a free and independent press. In a statement last year on the floor of the House of Representatives, Rep. Michael A. Andrews described advertising as ". . . the economic engine that provides the resources necessary for the media to supply the information the public needs and wants. Without advertising, media would become a State-run enterprise with all the constraints and burdens that entails."

Washington Post columnist Richard Harwood wrote earlier this year that "advertisers and the media need each other." Companies "advertise out of necessit the necessity to move goods in a competitive international economy in which even the biggest players . . . are insecure and struggling to survive," Harwood observed. He went on to comment that advertising ensured, in the last century, the economic independence of the American press from the control of government and political parties.

Advertising provides approximately 80 percent of the gross revenues of newspapers, with the remainder derived from subscription income. Most of the advertising revenue comes from retail and service industries, which are predominantly local businesses. Thus, it is the advertising that makes it possible for newspapers, radio, television and magazines to present a diverse offering of news, sports, weather, business, lifestyle, and entertainment information at a nominal cost to the consumer. It is axiomatic that if advertising is taxed, and therefore more expensive, advertisers will buy less of it and there will be less information and entertainment in the media.

Mr. Chairman, in conclusion, I cannot conceive of a tax proposal that more violates our American concept of fair play or a level playing field than does the proposal to limit the current deduction for advertising expenses. Nor can I think o a tax proposal that is more counterproductive at a time when we are attempting to stimulate our national and local economies. A limit on the deduction for advertisir costs would depress economic activity at a time when it is important to achieve productivity and efficiency in our economy. The effect would be to increase prices and reduce competition. At a time when Americans are benefiting more and more from broader sources of information and entertainment, at little or no cost because of its advertising support, it would tend to shrink the number of these multiple media outlets. And, at a time (in 1991) when daily newspapers have experienced the worst advertising revenues since World War II, it would impose a further penalty cost on our advertising-dependent industry.

Mr. Chairman, this Committee has a challenging task to meet the revenue needs of this country, and we appreciate the difficulty of your job. Nevertheless, w believe that the proposal to limit the deduction for advertising costs would be unfair, and anti-competitive, and would only contribute to slow growth, or no growth in our economy.

We, therefore, strongly urge you to reject this proposal.

Mr. PAYNE. Thank you, Mr. White.
Mr. Helm.

STATEMENT OF DEWITT F. HELM, JR., PRESIDENT, ASSOCIATION OF NATIONAL ADVERTISERS, INC., AND ALSO ON BEHALF OF THE ADVERTISING TAX COALITION

Mr. HELM. Thank you, Mr. Chairman, for those warm words of welcome.

For the benefit of the full subcommittee, my name is DeWitt Helm, and before becoming president of the Association of National Advertisers, 10 years ago, I was an advertising and marketing professional for 25 years with three well-known consumer product companies. I appear today on behalf of ANA and the Advertising Tax Coalition in strong opposition to the proposal that would impose a tax on advertising.

ANA represents virtually every manufacturing and service segment of industry. Our members account for approximately 80 percent of national and regional advertising expenditures, and the ATC represents 10 national trade associations whose members play a dominant role in advertising.

All of the members of our coalition strongly urge Congress to retain the full and current deductibility of advertising expenses. A tax on advertising would severely weaken a powerful economic engine that creates jobs, produces sales, and generates profits.

The proposal under consideration is bad public policy and bad tax policy. It would damage the business community, throttle the media, and stifle the efforts to invigorate our economy. Any limitation on the deductibility of advertising would make advertising more expensive and, like the Red Queen in Alice In Wonderland, companies would have to run faster by spending more on advertising each year merely to remain in the same place.

A decrease in advertising will translate into reduced sales and resonate throughout the economy. This tax would not only damage the country's largest advertisers but also hundreds of thousands of small businesses that advertise; every drug store, grocery store, general store, and hardware store in this country would feel the impact directly.

Proponents of limiting the advertising tax deduction argue that since some advertising may provide benefits for longer than 1 year, all advertising costs should not be taken fully in the year incurred, but most advertising is directed to the sale of a particular product or service in a very limited time frame. Advertising for supermarket specials, holiday and seasonal promotions, and classified advertising for houses and job openings fill the spaces of our national and local media.

In 1989 the ATC asked the late Dr. George Stigler of the University of Chicago and Dr. Kenneth Arrow of Stanford University, both winners of the Nobel Prize in economics, to carefully examine proposals to change the tax treatment of advertising, and after comprehensive analysis they concluded, "We do not believe that existing economic evidence supports proposed changes in the tax treatment of advertising."

Now, changing the tax treatment of advertising would also create an enormous administrative burden for both Government and business. Advertising simply is not a term of art. It does not have any fixed meaning. Will direct mail or signs in retail stores be considered advertising? Should brand or company logos on trucks or T-shirts be defined as advertising?

Developing working definitions will be complex, time consuming, and impose high compliance costs. There is simply no business, tax or public policy purpose served by singling out and discriminating against advertising through the Tax Code. At best, our Nation's economy is in a very sensitive phase, and it would take very little to throw it into a tailspin.

The incentive for American business simply should and must be to produce more profits, profits that will put people back to work. Let advertising do its job by driving the economic engine that creates sales, profit, and employment.

In conclusion, one Member of Congress recently told a group of advertising and media executives that trying to sell a product or service without advertising would be like a bird trying to fly without wings, and that metaphor captures better than most the message I hope to leave with this subcommittee today.

Advertising permits the consumer to make an informed choice from a range of options. I urge you not to clip its wings but to let advertising carry its message without an additional burden that would impede it from realizing its goal.

Thank you very much.

[The prepared statement follows:]

STATEMENT BY
DEWITT F. HELM, JR.
ON BEHALF OF
THE ASSOCIATION OF NATIONAL ADVERTISERS
AND
THE ADVERTISING TAX COALITION
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, D.C.

SEPTEMBER 8, 1993

Mr. Chairman, and members of the Subcommittee: Good morning. My name is DeWitt F. Helm, Jr. Before becoming President of the Association of National Advertisers, Inc. (A.N.A.) ten years ago, I was President of the Miller-Morton Company, then the consumer products subsidiary of a prominent multinational diversified pharmaceutical company. Previously, I also served as an advertising and marketing executive at Richardson-Vicks (now a part of Procter and Gamble) and Pfizer, Inc.

I am appearing today on behalf of A.N.A and the Advertising Tax Coalition in strong opposition to a proposal that would impose a tax burden on advertising. This proposal is both bad public policy and bad tax policy because it would damage the business community; severely harm the media; and adversely impact efforts to invigorate the economy.

A.N.A. represents virtually every segment of the business community. Our broad corporate membership includes, within its entities, over 2,000 subsidiaries, divisions, and operating units located throughout the United States. Our members market a vast range of products and services and employ advertising as an important element of their selling and public relations programs. A.N.A.'s members collectively account for approximately 80% of all national and regional advertising expenditures in the United States. Although A.N.A.'s membership includes most of the nation's largest advertisers, it also includes many smaller companies. A number of our members, for example, spend under 5 million dollars annually for advertising.

The ATC includes, in addition to our association, the American Advertising Federation, the American Association of Advertising Agencies, the Direct Marketing Association, the Grocery Manufacturers of America, the Magazine Publishers of America, the National Association of Broadcasters, the National Newspaper Association, the Newspaper Association of America, and the Yellow Pages Publisher's Association. Together, the members of these organizations play a dominant role in preparing and publishing or broadcasting the advertising produced in this country.

All the members of our Coalition strongly urge that Congress retain the full and current deductibility of advertising expenses. The full tax deductibility of advertising expenses provides enormous benefits to our nation's economy. Advertising generates the sales that lead to corporate profitability -- it is the most efficient means of selling ever devised. A tax burden on advertising would severely weaken an important economic engine that helps to create jobs, produce sales, and generate corporate profits.

From the vantage point of a former company president, and an advertising and marketing professional with over thirty-five years of real world experience, I offer, for your consideration, my perspective of the likely impact of the advertising tax proposal on the advertising and business communities. A business only has a certain portion of its operating budget to allocate to advertising in the course of a year, and any business will attempt to maximize the impact of its advertising. If a limitation were to be imposed on the deductibility of advertising costs, it would make the same amount of advertising more expensive. Like the Red Queen in

Alice in Wonderland, companies would have to run faster (or in this case, make larger expenditures) merely to remain in the same place.

If the tax deductibility of advertising is limited, companies would be forced to consider one or more of the following options:

1. Decrease their expenditures for advertising;

2. Reduce their work force or mandate other expense reductions in an effort to increase productivity so that they can apply "savings" to the increased cost of advertising in order to maintain the same communication levels.

3. or Shift expenditures, where possible, from advertising to promotional other communication vehicles that will continue to be fully tax deductible.

Before I expand on these three points, permit me to underscore the effect the recession already has had on business in general. As the Subcommittee knows, many of this country's most respected business entities have found it necessary to lay off tens-of-thousands of workers and to close major installations throughout this country in an effort to maintain economic viability and competitiveness. These companies, like all others, soon will be facing higher corporate taxes. A limitation on the tax deductibility of advertising will further increase their tax burden.

While companies can elect to decrease advertising budgets to compensate for the reduced deductibility of advertising, less advertising will translate into a reduction in sales for companies' goods and services. Reduced advertising will resonate throughout the economy. There will be less revenue for the advertising agencies that develop advertising and the media which carry advertising messages, including newspapers, television and radio stations, magazines, and other specialty publications. Reduced advertising also will mean less revenue for all those businesses that support and supply the advertising community.

Another option for companies will be to reduce their workforce, or to make other expense reductions. Theoretically, the "savings" from these cutbacks could be applied to a company's advertising budget in order to maintain current levels of advertising. Some people have suggested that companies instead could pass these higher costs on to the public. But, even a cursory reading of the business pages demonstrates that in this economy, it is virtually impossible for companies to raise prices. Companies that do risk a downturn in sales, and lower sales mean fewer jobs in the long run. Most companies, as already noted, face higher costs and are aggressively trimming budgets, and many now are laying off people in response to growing economic pressure and increasing competition.

Faced with higher advertising costs, another strategy for companies will be to shift advertising expenditures to promotion, or other communication vehicles that continue to be fully tax deductible. While it is well established that advertising is the most efficient method of selling to mass markets, less efficient methods will become more attractive if advertising is made more expensive because it is less than fully deductible. If advertising becomes more expensive, companies may shift to other communication vehicles, and if these vehicles are defined as advertising, companies may then resort to other options, including reductions in levels of communication.

This scenario highlights the difficulty of defining what constitutes advertising as companies concentrate on increasing public awareness of their products and services. The word "advertising" is not a term of art -- it does not have any fixed or agreed upon definition. Even the most experienced practitioners in the field often disagree as to what should be considered advertising and what should be excluded. Nevertheless, the proposal to limit the deduction for adverting costs will require the Department of the Treasury to make such a determination.

How will this determination be made to insure a fair tax policy? Will direct mail or signs in retail stores be considered advertising? What about decorated shipping containers which protect the product and are also used for display purposes? Should brand or company logos on trucks, tee-shirts, or other wearing apparel be defined as advertising? Should advertising be separated from other related communication vehicles such as "public relations" and "promotion?" These examples, of course, could be multiplied many times over. Developing working concepts will be complex, time consuming, and impose high compliance costs. But, all this highly technical effort and burdensome bureaucratic expense notwithstanding, these efforts still cannot avoid significantly hampering the selling process.

The members of A.N.A. are among the country's largest employers and most sophisticated advertisers. The three options I have outlined are the ones with which they will be faced if advertising becomes less than fully tax deductible as a business expense. But there are also hundreds-of-thousands of small businesses throughout the United States that will face the same difficult choices. These are not just small manufacturers or service based businesses, but grocery stores, drug stores, apparel stores, and hardware stores that make manufacturers' products available to consumers. At every step in the distribution process, advertising is the most effective and most efficient way to reach consumers -- but taxing advertising expenses will greatly reduce its efficiency.

When Wharton Econometrics Forecasting Associates, Inc. specifically analyzed the issue of limiting advertising deductions as it impacts small business, it concluded: "The impact of limiting the deductibility of advertising expenses should have a larger negative impact on small business than on large business . . . many new small business firms enter existing markets with the help of advertising -- it will make it more expensive for new small businesses to obtain a sufficient market share. These higher costs of entering markets will discourage the creation of new business and inhibit competition."

In fact, the advertising tax deductibility limitations proposal will impact particularly heavily on companies -- whatever their size -- that are attempting to introduce new products or break into new markets. These companies, furthermore, will find themselves competing against companies that developed market share at a time when they could immediately deduct 100% of their advertising expenses. Placing a burden on advertising, a key tool of economic competition, is clearly counterproductive.

Advertising is merely an integral part of the total marketing mix. Any "ordinary and necessary business expense" is geared to maximizing the sale of goods and services. A business expense in job training, research and development, public relations and advertising all lead business to the same goal. In light of that fact, is there any business, tax, or public policy purpose to be served by singling out and discriminating against advertising through the tax code? I strongly urge Congress not to head down the road of micro-managing the business process through differential tax treatment of the various segments of product development and the selling process. Furthermore, I believe that once we begin to head down this road it will be extremely difficult to turn back.

Proponents of limiting the advertising tax deduction have argued that since some advertising provides benefits for longer than one year, advertising costs should not be permitted to be taken fully in the year incurred. Unfortunately, while this argument initially may sound attractive, closer examination demonstrates such an approach will be administratively unworkable and economically damaging.

Most advertising is directed to the sale of a particular product or service in a very limited time frame. For example, supermarket advertising in newspapers for food specials, national TV seasonal and holiday promotions, buyer incentive programs, classified advertising for real estate, job openings, and a multitude of other goods and services all serve to fill the advertising space of our national and local media. To allow a small number of advertisements, that theoretically may have an impact in more than one year, to create a precedent for all other advertising is clearly unfair and inappropriate.

Furthermore, no one knows whether a new advertising campaign will be successful, or how long the effects of the advertising will last. Yet this proposal totally ignores the fact that most new product introductions, and their advertising, fail in the marketplace. How should we capitalize, for tax purposes, the famous campaign for the Edsel automobile? In fact, the number of new products being brought into the market has expanded drastically in the last few years, but the success rate has gone down. From 1980 to 1985, some 28,196 new items were brought onto the market, but only 12% succeeded. From 1985 to 1990, another 54,080 products were brought onto the market, but only 10% succeeded. Advertising is not magic. Nothing kills a bad product faster than good advertising. Without effective advertising, however, the odds of getting lost in the clamor of the competitive marketplace has increased exponentially.

In 1989, the Advertising Tax Coalition asked two winners of the Nobel Prize in Economics, the late Dr. George Stigler of the University of Chicago, and Dr. Kenneth Arrow of Stanford University, to carry out a comprehensive and systematic examination of proposals to change the tax treatment of advertising. Their findings were published in August of 1990. "Advertising is a powerful tool of competition," they wrote. "It provides valuable information about products and services in an efficient and cost effective manner. In this way, advertising helps the economy to function smoothly -- it keeps prices low and facilitates the entry of new products and new firms into the market."

Economists have long recognized the role of advertising in providing information. The basic economic model of perfect competition assumes that consumers have perfect information. In a groundbreaking study, for which he won the Nobel prize, however, Stigler showed that consumers rarely have such information -- hence the need for advertising.

Stigler and Arrow also noted, "Since the information conveyed by advertising is valuable, one must be particularly cautious about taxes that would raise the cost, and hence lower the quantity of advertising. Such taxes would reduce the overall flow of economic information available to consumers. As a result, we expect that prices would rise, the dispersion in prices for particular products would increase, and consumers would be less able to find goods that satisfy their preferences."

When commenting on the durability of advertising these two distinguished scholars wrote, "Our works points out how very difficult it is to obtain any general measure of the durability of advertising. In part, this is probably due to the fact that advertising is an extremely heterogeneous product and thus not easily measured; and in part, it is probably due to the fact that economists do not yet have a good testable model of the way in which advertising affects sales. In either event, we do not believe that existing economic evidence supports proposed changes in the tax treatment of advertising."

Stigler and Arrow concluded, "Although there are a number of economic studies that suggest that advertising is long-lived, they are generally so fraught with errors that one cannot rely on their findings. When we correct for some of the statistical problems, we find that estimated duration intervals are much shorter than originally thought. Moreover, there are a number of studies (particularly more recent ones) that suggest that advertising depreciates so rapidly that virtually all of its effects are gone within a year."

Critics of advertising also have suggested that advertising should be singled out for adverse tax treatment because other business expenses, in their view, such as research and development, are somehow more vital to the nation's economy. It is suggested that advertising is frivolous in comparison to these supposedly more important functions. But this view totally ignores the role advertising plays in our economy. It often has been claimed, that "if you build a better mouse trap the world will beat a path to your door." However, many companies have found that the improvements their research and development programs yield often are completely nullified if they do not effectively bring this information to the attention of the public through advertising.

In summary, the proposed limitation on the deductibility of advertising expenses is bad tax policy and bad public policy. There is no evidence that this tax would be absorbed automatically by corporate America without adversely affecting corporate profits. If corporate profits are reduced, the tax base itself would be reduced so that this form of taxation could prove to be counter-productive. The administrative burden on government and business would be laborious and inefficient as government assumed the responsibility for manipulating and micro-managing American business.

At best, our nation's economy is in a very sensitive phase -- it would take very little to throw it into a tail spin. Corporate tax rates already have been increased significantly in the largest tax increase in our history. Even so, I believe it is far preferable, more efficient, and much sounder tax and public policy to tax business profits, as Congress recently has done, rather than to interfere with the business process by taxing advertising.

The incentives for American business now should be, and must be, to produce more profits -- profits that will put people back to work. Let advertising do its job by driving the economic engine that creates sales, corporate profits, and employment. I urge you to reject disincentives that will be counterproductive, frustrate business, stifle corporate profits, and increase unemployment.

One member of Congress recently told a group of advertising and media executives that, "Trying to sell a product or service without advertising, would be like a bird trying to fly without wings." That metaphor captures better than most the message I hope to leave with this Subcommittee today. Advertising to the consumer, permits the consumer to make an informed choice from a range of options. I urge you not to clip its wings but to let advertising carry its message without an additional burden that would impede it in realizing its goal.

Mr. PAYNE. Thank you very much, Mr. Helm.

I feel like my colleague Mike Kopetski before me; I should announce my biases. I am strongly opposed to changing the tax treatment of advertising based on my own business background and the reliance of my business on consumer advertising, and second, because my wife is the owner of an advertising agency in central Virginia, and I feel like I may have heard this testimony before somewhere.

I do have several questions, though, that I would like to pose to this panel before we conclude. The first has to do, Mr. McConaghy, with something you brought up. You mentioned the AICPA had looked into this issue of advertising giving rise to benefits that extend beyond the current accounting period, and if that is true, should they be capitalized and amortized for an additional period. You mentioned that they had reached some conclusion. Could you just comment once again on the findings of the AICPA on this issue.

Mr. MCCONAGHY. Sure. First, Mr. Chairman, the pressure obviously for financial saving purposes is to allow amortization, because that, of course, spreads the deduction and therefore adds larger earnings per share. Nevertheless, with that pressure the financial accountants in the AICPA concluded that there really is no measurable future benefit. And therefore generally, except for one or two isolated cases, advertising has to be deducted currently for financial statement purposes and not capitalized.

Mr. PAYNE. Mr. Helm, it seems to me companies or corporations or entities that are selling goods and services have options among different media. They could advertise their products through a broadcast medium, the newspaper, public relations efforts or any number of ways. Could you comment on what kinds of changes would occur within the advertising business if this particular proposal became law?

Mr. HELM. Well, very simply, faced with this kind of a proposal becoming law, companies would have two or three options. One would be to simply reduce their expenditures in order to compensate for the effect of the tax. That is going to result in less communication, it will result in lower sales, it will result in lower corporate profits, in my judgment, and therefore less tax revenue, and so it will be counterproductive.

Another option is to try to reduce expenditures in other areas, be it R&D, be it in selling expenses in order to effect quote savings that can be applied to advertising. Frankly, I see this as placing the Government in a position of micromanaging American business, and I feel it would be much, much preferable to have the Congress continue to generate revenue through corporate profit taxes, through increases in the corporate profit tax. I am not advocating still another one on top of the recent one, but my plea is to tax profit, not interfere with process.

Mr. PAYNE. Would anyone like to comment then on how this proposal would affect industries? Are there certain winners and losers that might come about as a result of a proposal like this?

Mr. White.

Mr. WHITE. Yes, I would be happy to. Clearly in the spectrum of American business there are industries and individual companies that rely significantly more heavily, because of the inherent nature of their business, on advertising as the mix of their total expenses as opposed to, for instance, a more industrial-oriented company which places a lot of its investment in the R&D area and in direct contact with its customers, a much more limited customer base. So the very nature of the proposal is inherently discriminatory against those types of businesses that must of necessity rely more heavily on advertising than those who don't.

Mr. PAYNE. Mr. Gibian.

Mr. GIBIAN. I would like to add a point as a tax lawyer, and what would happen is that there would be a tremendous incentive for tax lawyers to find, in the complexity area, the areas that did not get disqualified as being current deductions, so you would have a whole new profession built up of tax professionals who would be trying to find ways and the means, no pun intended, to find those expenditures which would be deductible, and that in turn would create enormous complexity, as one of the other copanelists has commented on.

Mr. PAYNE. Mr. White.

Mr. WHITE. I think in addition to the straight complexity, it would have the very real likelihood of pushing advertising marketing and promotional efforts in many directions that most of us consider less desirable, more intrusive forms—telemarketing the direct sales calls, and so forth. Advertising is a more passive and hence, we believe, more benign approach to communication.

Mr. PAYNE. I want to thank you all very much for your testimony. It will be very useful to us as we continue to consider this and other revenue issues. Thank you very much.

Mr. PAYNE. Our fourth panel will continue testimony on the issue of the amortization of advertising expenses, and testimony on the depreciation of assets in the printing industry.

Would those who are carrying on conversations please take them outside the hearing room so that we can continue with our next panel.

Our first witness in this panel is with the Leadership Council on Advertising Issues, Sheldon S. Cohen, counsel with Morgan, Lewis and Bockius here in Washington, D.C.

Mr. Cohen, if you would proceed on the 5-minute rule please, thank you.

STATEMENT OF SHELDON S. COHEN, COUNSEL, LEADERSHIP COUNCIL ON ADVERTISING ISSUES

Mr. COHEN. Mr. Chairman, I certainly will. And I will summarize my testimony, I will not read it all. You have heard a lot today and you have got a lot more to hear.

Mr. PAYNE. Thank you, Mr. Cohen.

Mr. COHEN. I would like to discuss with you briefly a summary of my submission, why it is unsound economic and tax policy to capitalize advertising costs and to amortize them over a number of years.

It is elementary that advertising is an important element in our national economy. It increases demand for products which reduces their costs and results in the wonderful vibrant economy that is the envy of the world. Any change in the tax treatment will have serious economic ramifications.

Advertising costs have been treated as deductible items back to the beginning of the modern income tax, and indeed I was studying George Boutwell's manual to the 1862 income tax, and advertising costs were deductible in those days. There really isn't any future benefit, that has been discussed here.

The two or three instances where advertising results in capital goods, that is signs or other materials that last for 1 year or more than 1 year, or advertising campaigns that are directed toward future sales, that is a product that isn't on the market yet. Those costs right now have to be capitalized and amortized over the period of your usefulness or those costs which relate to the creation of a capital good have to be amortized. So we do have a dichotomy now, some are deductible—most are deductible, a very limited classification are capitalized and amortized now, and I think the concept that is thrown up here is misconceived.

An important element here, as has been discussed with you, is the GAAP role and the AICPA statement. There the accountants are working against their clients' interest, you see. The accountants are saying that we don't want to let you amortize those costs because that will increase your earnings per share, and that might be misstated, and therefore we want you to reflect a more conservative income to the current owners of your stock. That is a careful, well-thought through, well-conceived idea, and it goes to all of the SEC full disclosure rules and the fact that one shouldn't puff one's income, one shouldn't puff it for tax purposes, either.

The complications are myriad. Presently there are a number of accounting treatments that are different for tax and for bookkeeping purposes. We should not multiply those because each one creates another justification for another one, and each of those creates complications. They have to be accounted for separately, they have to be reconciled to books. There are adjustments on the tax return; the schedule M on the tax return has to justify those items. Those are each complications both for the taxpayer and for the Government, just equally for the Government.

I might remind the chairman that the chairman of the whole committee, Mr. Rostenkowski, said in discussing this just last year that the amortization, the rule that was put in for intangibles would not be used as a justification for capitalizing advertising costs and amortizing them over a period of time.

So, in summary, I would say that the committee has been searching for a number of years now for ways to simplify the Internal Revenue Code. One of the most important ways to simplify the Internal Revenue Code is not to add complications. Certainly this kind of concept would add further complications.

Thank you, sir.

[The prepared statement and attachments follow:]

STATEMENT OF SHELDON S. COHEN
LEADERSHIP COUNCIL ON ADVERTISING ISSUES

TAX POLICY AND ECONOMIC ISSUES RELATED TO DEDUCTIBILITY OF ADVERTISING UNDER FEDERAL TAX LAW

I. Introduction

I am Sheldon S. Cohen, a partner in the law firm of Morgan, Lewis & Bockius. I appear as a representative of the Advertising Leadership Council, a coalition of major advertisers, advertising agencies, and media companies.[1] The Advertising Leadership Council asked me to discuss why it is unsound, from a tax policy and economic perspective, to require that advertising costs be capitalized and amortized over a period established by statute.

Advertising expenses are a major component of the national economy. Advertising encourages both competition and growth of business. Advertising takes many forms, from commercials on radio and television, to print advertisements in newspapers and magazines, to billboards, blimps, and the sponsorship of sporting events. It is used to introduce new products and services, or to convey information about prices and availability. Advertising reminds consumers of their favorable experiences with particular products or services. Advertising does not motivate people to purchase products with which they had an unfavorable experience or which have not lived up to their expectations.

Any change in the present treatment of advertising costs will have serious economic repercussions. Advertising costs are deductible under present law because they are generally incurred to produce current revenues. The amortization of advertising costs over a period of years would distort the matching of these expenses with related revenues and would greatly complicate the filing of tax returns.

II. Federal Tax Treatment of Advertising Expenses

Section 162 of the Internal Revenue Code allows a current deduction for ordinary and necessary business expenses.[2] Section 263 prohibits deductions for any amount paid to acquire an asset or to increase the value of any asset. The primary effect of characterizing a business expenditure as either a business expense or a capital expenditure concerns the timing of the taxpayer's cost recovery. A business expense is currently deductible, whereas a capital expenditure is usually amortized over the life of the relevant asset.

Through sections such as 162 and 263, the Code endeavors to match deductions with benefits over the period during which the benefits are enjoyed. The matching of deductions and income results in a more accurate calculation of net income for tax purposes. Generally, if an expenditure produces significant benefits that extend beyond the year in which the expenditure is made, that expenditure is capitalized. An example would be legal and accounting fees incurred in connection with a corporate merger or acquisition.[3] Moreover, if an expenditure contributes to the creation or enhancement of a separate, identifiable asset, that expenditure is generally capitalized and amortized.[4] An example would be costs incurred to develop a patent or trademark.

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[1] A list of the members of the Advertising Leadership Council is attached as an appendix hereto.

[2] All references to "sections" are to sections of the Internal Revenue Code of 1986, as amended. The rule enunciated in section 162 has been consistently applied since the advent of the modern income tax early in this century.

[3] Indopco, Inc. v. Commissioner, 112 S.Ct. 1039 (1992).

[4] Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345 (1971).

Advertising expenses have long been recognized as ordinary and necessary business expenses. All advertising expenses that are reasonably related to the taxpayer's trade or business are currently deductible, including amounts spent on goodwill or institutional advertising.[5] The law in this area is so established that the IRS and the courts have rarely questioned the deductibility of advertising expenses.

Proponents of capitalization of advertising expenses have argued that such expenses produce benefits lasting beyond one year, either in the form of future income or in the form of a separate intangible asset like goodwill or product/brand-name loyalty.[6] They generally have been seeking this change as a revenue-raising measure to offset changes which would cost revenue. Advocates of this position erroneously state that advertising produces benefits or revenues extending beyond the current tax year.

Advertising costs do not produce significant benefits extending beyond the current tax year. Product advertising -- such as a retail electronic store's advertisements for a holiday sale -- does not generate revenues beyond the period that the advertisement is published or broadcast. Another example familiar to most Washingtonians is the weekly advertising supplement for Giant Food. This advertisement prominently features the food and drug items on sale and the prices for such items. The "product" being sold is the particular item at the advertised price and this advertisement produces benefits for Giant Food only so long as the company offers that product at that price.

Institutional or goodwill advertising, such as a general advertisement by a corporation to keep the corporation's name in the minds of the public, generally does not generate revenues beyond the current year. Institutional or goodwill advertising is typically done by large companies, and usually on a regular basis. There may be incidental future benefits from institutional or goodwill advertising, but they are insignificant and impossible to quantify. These benefits depend on each individual consumer's recollection of an advertisement in a future year. For example, if a consumer purchases a Toyota in 1994, is it due to the commercial he saw in 1992 or 1993, the commercial he saw the night before he bought the car, or the cumulative effect of seeing advertisements for a Toyota from 1992 through 1994?

Under present law, advertising expenses have been capitalized in two instances. The first instance is when the expenses relate to a tangible asset, such as a sign or a billboard, or an intangible asset, such as the rights to package designs. In this first instance, it is appropriate to amortize the billboard or the package design over its useful life. The second instance in which advertising expenses have been capitalized is when the terms of the advertisement explicitly extend beyond the current tax year, such as an advertisement for a product that will be unavailable until the following year.

III. Matching Principle and Book/Tax Parity

As I have stated, the tax law attempts to match expenses with the revenues generated by such expenses to accurately measure net income for tax purposes. Generally accepted accounting principles ("GAAP") have the same goal. While the tax accounting treatment of an item is not necessarily dictated by book accounting principles,[7] those principles are often helpful in deciding whether an expense should be deducted or capitalized.

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[5] See Treas. Reg. § 1.162-20(a)(2).

[6] See, e.g., Congressional Budget Office, Selected Spending and Revenue Options, 134, June 1991 (hereinafter "CBO Papers").

There is currently no GAAP governing the treatment of advertising costs. Some businesses deduct advertising costs when paid or incurred whereas some businesses capitalize advertising costs and amortize them over a period of years. However, an AICPA subcommittee has promulgated a proposed Statement of Position ("SOP") which would treat advertising costs as deductible when paid or incurred unless (a) the advertising is "direct-response advertising" or (b) the costs are for billboards or blimps which are used for several advertising campaigns. I understand that this proposed SOP has been approved by the FASB and is set to be released this quarter.

If costs are for direct-response advertising, such costs would be reported as "assets" and written off over the estimated period of the benefits. The proposed SOP defines direct-response advertising as advertising intended to persuade a customer to purchase a company's products or services by responding specifically to the advertisement (i.e., by means of a coded order form included with an advertisement, a coded coupon turned in by a customer, etc.). This proposed rule is similar to the rule for tax purposes, which requires capitalization of advertising costs when it is certain that the benefits extend to future periods.[8]

The proposed GAAP exception for billboards and blimps is identical to the rule for tax purposes. For example, a corporation that uses signs or billboards to advertise its products must capitalize the cost of the sign or billboard and amortize it over the respective asset's useful life for federal tax purposes.[9]

Neither product advertising nor institutional and goodwill advertising generate significant benefits or revenues beyond the current tax year. Thus, it would be violative of the matching principle to require that advertising costs be capitalized and amortized over an arbitrarily determined period. Absent policy justifications for departing from the matching principle, the tax law should be consistent with book accounting principles. Otherwise, you will add new complications to schedules required to reconcile such differences.

IV. Capitalization of Advertising Costs Would Conflict With Long-Standing Case Law and IRS Rulings

A. Advertising costs do not create or enhance a separate intangible asset

The Supreme Court held in Lincoln Savings that premiums paid by a savings and loan to the FSLIC for a secondary reserve fund should be capitalized because the premiums created or enhanced a separate and distinct additional asset (i.e., the reserve fund).[10] As clarified by the recent Indopco decision, the creation or enhancement of a separate asset, while not a prerequisite to capitalization, will certainly suggest that capitalization is appropriate.

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[7] I.R.C. § 446(a); see Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979); see also American Auto. Ass'n v. United States, 367 U.S. 687 (1961).

[8] See Rev. Rul. 68-283, 1968-1 C.B. 63 (amounts paid to a corporation for advertising and promoting the taxpayer's products at a fair resulted in benefits extending beyond one year because the fair operated for six months in each of two years).

[9] See Alabama Coca-Cola Bottling Co. v. Commissioner, 28 T.C.M. (CCH) 635 (1969) (cost of "Coke" signs placed by a bottler into retailers' stores had to be capitalized and amortized over the useful lives of the signs).

Proponents of the capitalization of advertising costs erroneously believe that advertising is a substantial contributor to the creation of a separate intangible asset.[11] Their argument is that a company's sales receipts would decline dramatically if advertising were curtailed or eliminated. Thus, advocates of this view reason that advertising creates an assurance that customers will make purchases next week, next month, and next year. They assert that this assurance of continued customer purchases is itself an intangible asset, much like purchased goodwill. Whether this intangible is denoted "goodwill," "brand loyalty," or something else, its effects are said to be long-lived. On this basis, it is stated that such expenses are capital in nature and should be fully or partially capitalized rather than deductible in the year incurred.[12]

The fundamental flaw in this analysis is a misunderstanding of the functions performed by advertising. A decline in advertising would certainly reduce a company's sales over time, but this would be the result of a reduced amount of information provided to consumers. It is simply untrue that long-term customer loyalties -- namely, the assurance that current customers will buy a company's goods in future years -- are created by this year's advertising costs.

Although advertising is a valuable activity to advertisers and consumers alike, advertising itself does not create something of value. In fact, to serve its business purpose of conveying information, advertising must be repeated over and over as it does not have long-term staying power. Consider three categories of advertising: (a) advertising of new, improved, or expanded products or services, (b) advertising of products that are available for a limited time or are on sale, and (c) institutional or goodwill advertising.

First, for a new, improved, or expanded product or service, advertising is critically important. New product advertising is intended to generate immediate interest, attention, and sales.

Second, for time-sensitive information about a product or service, such as a sale price or limited availability, advertising is the most effective means of informing potential customers about the product or service being offered. Grocery stores and general merchandise retailers make extensive use of such advertising on a daily or weekly basis. Automobile dealerships and airlines and other businesses utilize such advertising when they offer discount fares or other limited-time features to consumers.

Long-term sales are not the purpose of either of these two forms of advertising. Indeed, the information presented in such advertising is usually out-of-date within a few days or weeks.

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[10] Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345 (1971).

[11] "A Little Too Creative, "Forbes, July 1990; James Dezart, "New Turns in the Slugfest on Amortizable Intangibles," Mergers & Acquisitions, March/April 1991; "Time Is Right for Washington to extend Tax Deductibility to Purchased Goodwill," American Banker, March 20, 1991.

[12] See CBO Papers at 134.

Such advertisements would be worthless or even counterproductive if continued for an extended period.

The third general category of advertising, which appears to have given rise to the amortization proposals, is institutional or goodwill advertising. This is advertising intended to remind customers of the company's name or to convey general information rather than new product or time-sensitive information. Some have argued that this category of advertising is an effort to develop an intangible such as goodwill or brand loyalty that will bring the customer back for additional purchases in future years. For this reason, such advertising is thought to be a capital expenditure rather than a deductible expense.

Granted, customers develop loyalties to a product or a service. However, such loyalty is due to favorable experiences in the past. Quality and reliability create repeat sales, as well as encourage sales of a new product produced by a trusted company. Many factors contribute to quality and reliability, such as research and development, experienced and well-trained employees, good technology and equipment, high quality-control standards and so on. These are the expenses that produce the intangible value. Advertising reminds the customer of his or her satisfaction with that quality, but it does not create that quality. Thus, advertising creates a short-hand summary for the customer of the quality associated with the company or particular product or brand name. The summary may come in the form of specific information in an advertisement. Or, the mere mention of a company name or brand name may trigger the customer's mental summary.

Accordingly, while advertising performs critically important informational functions, it does not create or enhance an intangible asset with a useful life that extends beyond the taxable year. The only intangible is the one created by the quality of the customer's past experience with the product or service.

B. Advertising costs do not create significant benefits that extend beyond the current tax year

Some proponents of capitalization argue that advertising produces benefits that extend beyond the year in which the advertising occurred. This conclusion is unsupported by any empirical evidence, principally because it is nearly impossible to gather and measure any data to substantiate such a claim.

The Supreme Court's recent decision in Indopco does not require the capitalization of advertising costs. In Indopco, the Supreme Court found that merger expenses had to be capitalized even though they did not create or enhance a separate asset. The expenses at issue in Indopco related to a specific corporate transaction. The Court relied on established precedent, which held that expenses incurred in connection with a change in corporate structure are capital expenditures. Moreover, the transaction created unmistakable benefits extending beyond the current year.

In the case of advertising, there is no corporate transaction involved or other identifiable capital event. Thus, there is simply no way to measure the duration or fact of any future benefit generated by advertising. Of the three general categories of advertising already discussed, only institutional or goodwill advertising could be said to have long-term effectiveness. However, numerous factors may combine to influence the duration of an advertising campaign's success.[13]

13/ Kenneth J. Arrow, Economic Analysis of Proposed Changes in the Tax Treatment of Advertising Expenditures, 1990 p. 22.

The consumer's interest in the subject and ability to remember must be considered.[14] These factors are so individualized as to be virtually impossible to quantify. Additionally, the success and duration of every advertising campaign is necessarily affected by the intensity of the competition's advertising.[15]

Even advertising that is meant to have long-term results may fail to do so. One of the most notoriously unsuccessful advertising campaigns was that for the Edsel in the 1950s. The advertisers of the Edsel hoped to present the public with a product it would remember and enjoy for years, but the advertising failed to do so.[16] A more recent example of failed advertising was the advertising blitz for "New Coke," which not only initially hurt Coca-Cola's business, but wound up helping the company's sales in an area unintended by the "New Coke" campaign, by ultimately increasing sales of "Classic Coke."

Advertising may also establish a company's name or product in the mind of the consumer without increasing sales.[17] Economic studies which have attempted to measure the lifespan of advertising generally have been problematic, but most results show that advertising depreciates rapidly with effects rarely surviving as long as a year.[18]

It makes little sense then to capitalize an expenditure that does not contribute to a significant benefit lasting beyond the year in which the expenditure is made, particularly an expenditure that is otherwise an "ordinary and necessary" business expense. The current federal tax treatment of advertising wisely reflects this reality. The Service has taken the position in a 1992 revenue ruling that the Indopco analysis is inapplicable to advertising expenses. According to the Service, advertising expenses "are generally deductible under . . . section [162] even though advertising may have some future effect on business activities, as in the case of institutional or goodwill advertising."[19] Advertising expenses are to be amortized only "in the unusual circumstance where [the] advertising is directed towards obtaining future benefits significantly beyond those traditionally associated with ordinary product advertising or with institutional or goodwill advertising."[20]

Finally, capitalization of advertising costs on the basis that such costs create benefits extending beyond one year would call into question the treatment of certain other ordinary and necessary business expenses that arguably have a future benefit component. For instance, reasonable compensation paid to an officer is generally deductible under section 162 even though it is reasonable to assume that the officer being paid currently is engaged in long-term planning that extends beyond the current year. Currently, the IRS and the courts require compensation to be capitalized only when the recipient is performing services in connection with a capital transaction. Otherwise, they do not get involved in a case-by-case determination of whether the recipient's services produce benefits beyond one year. This is a complication which the Government and taxpayers can live better without.

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[14] Id.

[15] Id.

[16] Id.

[17] Id.

[18] Id.

[19] See Rev. Rul. 92-80, 1992-2 C.B. 57.

[20] Id.

V. There is No Justifiable Policy Reason for Setting an Arbitrary Write-Off Period for Advertising Costs

As the previous discussion demonstrates, it is virtually impossible to quantify the long-term benefits of institutional or goodwill advertising. It has been recognized that, "because the useful life of advertising depends on its unknown effect on customers, any amortization rate would be arbitrary."[21] Imposition of an arbitrary write-off period with absolutely no basis in economic reality is unjustified, particularly given the heavy administrative burdens that this proposal would inflict on both taxpayers and the Government.

The proposal would require taxpayers to maintain annual accounts of their advertising expenses for years to come and would increase the Government's administrative costs of policing this change in the law. If the tax law is changed to require that advertising costs be capitalized, there would be different treatment of advertising costs for tax and book accounting purposes. Every new distinction between GAAP and tax accounting creates new reconciliations to be accounted for as Schedule M-1 adjustments on Form 1120. This is a complicating factor for both taxpayers and the Government.

In exchange for these heavy administrative costs, the proposal would merely defer a portion of current costs to the future. As such, the proposal would generate additional revenue only in the first several years following enactment. To illustrate this point, assume that a corporation spends annually $100 on advertising and thus under current law deducts $100 each year on its Form 1120 for advertising expenses. If, for the sake of argument, Congress enacts a provision requiring amortization of advertising expenses over a three-year period, the corporation's $100 annual deduction would be limited only for the first two years following enactment of the write-off provision.

In year one, the corporation would be entitled to deduct only one-third of the $100 expense for year one, or $33, and, in year two, the corporation would be entitled to deduct only one-third of the $100 expense for year two and one-third of the $100 expense from year one, or a total of $66. Beginning in year three, however, the corporation would be entitled to a $100 annual deduction, computed in year three as the sum of one-third of the $100 expense for year three, one-third of the $100 expense from year two, and one-third of the $100 expense from year one, for a total of $100.

VI. Congress Has Repeatedly Chosen to Uphold the Deductibility of Advertising Expenses

Like the IRS, Congress has also had a recent opportunity to consider the deductibility of advertising expenses. As part of the Revenue Reconciliation Act of 1993, Congress adopted new Code Section 197, which permits goodwill and other intangible assets to be written off over 15 years in certain circumstances. In considering the breadth of this provision, Chairman Rostenkowski reaffirmed the continued vitality of the deductibility of advertising expenses: "Some persons have questioned whether this bill [section 197 on amortization of intangibles] was intended to

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21/ *See* CBO Papers at 134.

open the door for reconsidering tax deductions for advertising expenses. Let me be clear. The answer is, no."[22]

VII. Conclusion

The historical treatment of advertising as a deductible business expense is sound and reasonable and should be upheld. Current deductibility of advertising costs comports with proposed GAAP reporting requirements and is consistent with the tax law's matching principle.

Advertising does not create goodwill, brand loyalty, or similar intangibles. Customers' past experiences with a product's or service's reliability and quality determine future purchase decisions. Many expenditures contribute to the creation of such quality, including research and development, employee training, customer service, and the like. These are the expenditures that create intangible value, not advertising costs.

Further, it is nearly impossible to establish that advertising has any measurable effects on business that extend beyond the year in which the advertising occurred. Thus, establishment of an arbitrary write-off period with no basis in economic reality would be unjustified.

22/ See Unofficial Transcript of Oct. 2 Ways & Means Comm. Hearing on Amortization of Intangibles, 91 TNT 208-26 (Statement of Chairman Rostenkowski), quoted in John W. Lee, Doping Out The Capitalization Rules After Indopco, 57 Tax Notes 669, 683 n.126 (Nov. 2, 1992).

Advertising Leadership Council

American Express Company

Backer Spielvogel Bates Worldwide, Inc.

Black Entertainment Television

D'Arcy, Masius, Benton & Bowles

Frito-Lay, Inc.

H. J. Heinz Company

Hublein

Interactive Telemedia

The Interpublic Group of Companies, Inc.

Kraft General Foods

Leo Burnett Company

Mars, Incorporated

Mattel, Inc.

Nestle U.S.A.

Nynex Corporation

Ogilvy & Mather Worldwide

Philip Morris Companies Inc.

Joseph E. Seagrams & Sons, Inc.

Tatham/RSCG

Time-Warner Inc.

Unilever United States, Inc.

Univision

The Washington Post Company

Young & Rubicam

Mr. PAYNE. Thank you, Mr. Cohen.

The next panelist is representing the National Retail Federation, David Feeney, senior vice president in the corporate tax department of R.H. Macy Co. in New York.

Mr. Feeney.

STATEMENT OF DAVID L. FEENEY, SENIOR VICE PRESIDENT, CORPORATE TAXES, R.H. MACY AND CO., INC., ON BEHALF OF THE NATIONAL RETAIL FEDERATION

Mr. FEENEY. Thank you. Mr. Chairman, members of the committee, my name is David Feeney. I am senior vice president, corporate taxes, as you just pointed out, for R.H. Macy. I am pleased to appear today on behalf of the National Retail Federation to express our opposition to a proposal to capitalize advertising costs and amortize them over a period of years.

By way of background, the National Retail Federation is the Nation's largest trade group that speaks for the retail industry. The organization represents the entire spectrum of retailing, including the Nation's leading department, chain, discount, specialty, and independent stores, several dozen national retail associations, and all 50 State retail associations. The federation's membership represents an industry that encompasses over 1.3 million U.S. retail establishments, employs nearly 20 million people and registered sales in excess of $1.9 trillion in 1992.

The retail industry would be severely harmed by a proposal to capitalize advertising. Our industry relies on advertising to bring customers into our stores on a day-by-day basis. This is an ordinary and necessary cost of doing business for retailers. There is no good tax policy basis for denying taxpayers the ability to deduct these costs as incurred. It is also bad economic policy to increase our cost of advertising, which directly affects sales. The ripple effect on the economy will be to reduce production and lower economic growth.

Advertising fosters competition. When a business advertises prices and quality, it forces competitors to lower prices and increase quality. Advertising is also the means by which new products can enter into a market. Increasing the cost of advertising will disproportionately hurt businesses that are trying to market new products. The results will be less innovation and a drag on U.S. global competitiveness.

Advertising also provides customers with an important source of information about products, including price and quality. It provides competition within the marketplace, and it also helps to bolster consumer confidence. With consumer confidence at its current low point, our Government cannot afford to adopt a policy that would be a further detriment to consumer confidence. Rather, stronger consumer confidence is needed to help generate an economic recovery.

In addition, increased advertising costs will have a particularly harsh impact on financially troubled retailers, some of which already may be in bankruptcy. Businesses that are strapped for cash, and in particular financially troubled retailers, use advertising as a means of producing a quick boost in sales and to increase their cash flow. It would be difficult for these businesses to bear the increased costs of this advertising. It may affect their ability to survive, and it could result in a loss of jobs for many Americans.

Under current law, advertising costs generally are deducted in the year incurred as a cost of doing business. This is the same tax treatment that is given to a myriad of other business expenses that are generally considered period costs. Tax law also provides that recurring expenditures are currently deductible because of the need to renew the benefits through additional expenditures each year, suggesting a useful life of less than a year. Advertising generally is considered a recurring expenditure because taxpayers must regularly engage in advertising activities in order to produce new business on a relatively consistent basis in each year.

There is no tax incentive for engaging in advertising activities, nor is there any other special "tax break" for advertising. Retailers engage in advertising on a day-to-day basis in order to inform customers about current products, prices, and to bring customers into our store. Hopefully, this translates into immediate sales. The costs of the business activity of generating sales are deducted from income in the year incurred in order to properly match the revenues with expenses of generating the revenues.

Other than serving as a revenue raiser, the tax policy basis that has been suggested for requiring the capitalization of a portion of advertising expenses is that the revenue stream or benefit generated from advertising extends to future years. From a retailer's perspective, I can state emphatically that this is not the case. Retail advertising is directed at the sale of goods directly to consumers within a short period of time. The advertisement may announce a sale of a product, a special promotion associated with the product or the availability of the product at a particular store. In all of these cases, the goal is to bring the customer into the store during the time the sale or promotion is taking place. Again, the purpose is to generate immediate sales. For example, a newspaper ad announcing the price of chicken for the coming week is designed to bring customers into the store during that week to purchase chicken. The advertisement will have no value after that week.

Seasonal advertising is similar. Advertisement directed at Christmas sales clearly are directed at short-term results, as are sales of ski equipment, bathing suits, and other items of use only during certain times of the year. In such cases, products that are advertised for sale in a particular store this month may not even be offered for sale in that store in future years.

Proposals to require capitalization of advertising expenses will also add a great deal of complexity to the Tax Code. The primary reason for the complexity will result from trying to make determinations as to what activities actually constitute advertising. For example, if an advertising agency is hired, are all fees paid to the agency considered to be advertising, or are research and other consulting services not advertising? Are salaries paid to store employees, who deal with ad agencies and do other advertising and marketing activities, considered to be advertising costs?

If the store puts its label in a coat that it sells, is that advertising? Is the store's name on the bill that it sends to its credit card customers advertising? Are product demonstrations in the store advertising? Are telephone and mail solicitations advertising?

If advertising is broadly defined, capitalization will be difficult for the Internal Revenue Service to administer. However, if a narrower definition of advertising is used, then sellers of goods and services will be encouraged to switch to a form of marketing that is deductible. Thus, the tax law will influence sellers to use a less efficient means of marketing.

In either case, the issue of what constitutes "advertising" will lead to innumerable controversies between taxpayers and the Internal Revenue Service, leading to years of litigation. This is exactly the opposite of the goals set by this committee to simplify our overly complex tax system.

In summary, the National Retail Federation opposes any proposal to restrict the deduction for advertising costs. Retailers rely on advertising to bring customers into our stores and make sales, which leads to stronger economic growth. There is no tax policy justification for limiting a retailer's deduction for this cost of doing business. This would distort the basic premise of matching revenues and expenses. In addition, advertising contributes to the sale of new and innovative products, which are needed to keep our Nation competitive. Finally, modifying the tax rules relating to advertising would add a great deal of complexity to the Tax Code and result in innumerable controversies between taxpayers and the IRS over the definition of advertising.

Mr. Chairman and members of the committee, I thank you for your time and kind attention.

[The prepared statement follows:]

STATEMENT OF DAVID L. FEENEY
NATIONAL RETAIL FEDERATION

Mr. Chairman, members of the Committee, my name is David L. Feeney, Senior Vice President -- Corporate Taxes, of the R.H. Macy & Co., Inc. I am pleased to appear today on behalf of the National Retail Federation to express our opposition to a proposal to capitalize advertising costs and amortize them over a period of years.

By way of background, the National Retail Federation is the nation's largest trade group that speaks for the retail industry. The organization represents the entire spectrum of retailing, including the nation's leading department, chain, discount, specialty and independent stores, several dozen national retail associations and all 50 state retail associations. The Federation's membership represents an industry that encompasses over 1.3 million U.S. retail establishments, employs nearly 20 million people and registered sales in excess of $1.9 trillion in 1992.

The retail industry would be severely harmed by a proposal to capitalize advertising. Our industry relies on advertising to bring customers into our stores on a day-to-day basis. This is an ordinary and necessary cost of doing business for retailers. There is no good tax policy basis for denying taxpayers the ability to deduct these costs as incurred. It is also bad economic policy to increase our cost of advertising, which directly affects sales. The ripple effect on the economy will be to reduce production and lower economic growth.

Advertising fosters competition. When a business advertises prices and quality, it forces competitors to lower prices and increase quality. Advertising is also the means by which new products can enter into a market. Increasing the cost of advertising will disproportionately hurt businesses that are trying to market new products. The results will be less innovation and a drag on U.S. global competitiveness.

Advertising also provides customers with an important source of information about products, including price and quality. It provides competition within the marketplace, and it also helps to bolster consumer confidence. With consumer confidence at its current low point, our government cannot afford to adopt a policy that would be a further detriment to consumer confidence. Rather, stronger consumer confidence is needed to help generate an economic recovery.

Increased advertising costs will have a particularly harsh impact on financially troubled retailers, some of which already may be in bankruptcy. Businesses that are strapped for cash, and in particular financially troubled retailers, use advertising as a means of producing a quick boost in sales to increase their cash flow. It will be difficult for these businesses to bear the increased cost of this advertising.

Similarly, increased advertising costs will be harmful to small businesses, and especially small retailers, that rely on increased sales as a result of advertising to provide the basis for building their businesses.

Advertising Increases Short-Term Sales

Under current law, advertising costs generally are deducted in the year incurred as a cost of doing business. This is the same tax treatment that is given to a myriad of other business expenses that are generally considered period costs. Tax law also provides that recurring expenditures are currently deductible because of the need to renew the benefits through additional expenditures each year, suggesting a useful life of less than a year. Advertising generally is considered a recurring expenditure because taxpayers must regularly engage in advertising activities in order to produce new business on a relatively consistent basis in each year.

There is no tax incentive for engaging in advertising activities, nor is there any other special "tax break" for advertising. Retailers engage in advertising on a day-to-day basis in order to inform customers about current products and prices and bring customers into our stores. Hopefully, this translates into immediate sales. The costs of the business activity of generating sales are deducted from income in the year incurred in order to match revenue with the expenses of generating the revenue.

Other than serving as a revenue raiser, the tax policy basis that has been suggested for requiring the capitalization of a portion of advertising expenses is that the revenue stream or benefit generated from advertising extends to future years. From a retailer's perspective, I can state emphatically that is not the case. Retail advertising is directed at the sale of goods directly to consumers within a short period of time. The advertisement may announce a sale of a product, a special promotion associated with the product, or the availability of the product at a particular store. In all of these cases, the goal is to bring the customer into the store during the time that the sale or promotion is taking place. Again -- the purpose is to generate immediate sales. For example, a newspaper ad announcing the price of chicken for the coming week is designed to bring customers into the store during that week to purchase chicken -- the advertisement will have no value after that week. Seasonal advertising is similar. Advertisements directed at Christmas sales clearly are directed at short term results, as are sales of ski equipment, bathing suits, and other items of use only during certain times of the year. In some cases, products that are advertised for sale in a particular store this month may not even be offered for sale in that store in future years.

Economic studies confirm that the value of most advertising is eliminated within one year. A recent study co-authored by two Nobel Laureates in economics, Dr. Kenneth J. Arrow and Dr. George G. Stigler, concludes:

> [A]lthough there are a number of economic studies that suggest that advertising is long-lived, they are generally so fraught with errors that one cannot rely on their findings. When we correct for some statistical problems, we find that the estimated duration intervals are much shorter than originally thought. Moreover, there are a number of studies (particularly more recent ones) that suggest that advertising depreciates so rapidly that virtually all of its effects are gone within a year. In short, the economic evidence does not support the view that advertising is long-lived.[1]

Requiring Capitalization Will Greatly Increase the Complexity of the Tax Code

Proposals to require capitalization of advertising expenses will add a great deal of complexity to the tax code. The primary reason for the complexity will result from trying to make determinations as to what activities constitute advertising and what activities do not. For example, if an advertising agency is hired, are all fees paid to the agency considered to be for advertising, or are research and other consulting services not advertising? Are salaries paid to store employees who deal with ad agencies and do other advertising and marketing activities considered to be advertising costs? If a store puts its label in a coat that it sells, is that advertising? Is the store's name on the bills it sends to its credit card customers advertising? Are product demonstrations in the store advertising? Are telephone and mail solicitations advertising?

If advertising is defined broadly, capitalization will be difficult for the Internal Revenue Service to administer. However, if a narrower definition of advertising is used, then sellers of goods and services will be encouraged to switch to a form of marketing that is deductible. Thus, the tax law will influence sellers to use a less efficient means of marketing.

In either case, the issue of what constitutes "advertising" will lead to innumerable controversies between taxpayers and the Internal Revenue Service -- leading to years of litigation. This is exactly the opposite of the goals set by this Committee to simplify our overly complex tax system.

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[1] Kenneth J. Arrow, George G. Stigler, Elisabeth M. Landes, and Andrew M. Rosenfield, Economic Analysis of Proposed Changes in Tax Treatment of Advertising Expenditures, Lexicon, Inc., Chicago, April 1990 at 39-40.

Conclusion

In summary, the National Retail Federation opposes any proposal to restrict the deduction for advertising costs. Retailers rely on advertising to bring customers into our stores and make sales, which leads to stronger economic growth. There is no tax policy justification for limiting a retailer's deduction for this cost of doing business. This would distort the basic premise of matching revenues and expenses. In addition, advertising contributes to the sale of new and innovative products, which are needed to keep our nation competitive. Finally, modifying the tax rules relating to advertising would add a great deal of complexity to the tax code and result in innumerable controversies between taxpayers and the Internal Revenue Service over the definition of advertising.

Mr. PAYNE. Thank you very much, Mr. Feeney.

Our next two witnesses will be testifying concerning the depreciation of assets in the printing and publishing industry. We will first hear from Mr. Webber.

STATEMENT OF HOWARD C. WEBBER, JR., CHAIRMAN, COHBER PRESS, INC., ROCHESTER, N.Y., ON BEHALF OF THE PRINTING INDUSTRIES OF AMERICA, AND GRAPHIC ARTS LEGISLATIVE COUNCIL

Mr. WEBBER. Thank you. Mr. Chairman, members of the subcommittee, my name is Howard C. Webber, Jr. I am the chairman and CEO of Cohber Press, Inc., a 58-employee commercial printing firm located in Rochester, N.Y. I am a former chairman of the board of the Printing Industries of America, the largest printing and graphic arts trade association in the United States, with over 14,000 member companies.

I am appearing before you today on behalf of the Graphic Arts Legislative Council, a group of national graphic arts associations formed in 1988 to provide a forum for addressing legislative and regulatory proposals before Federal and State government. The council consists of 14 associations representing every aspect of the printing and graphic arts industry.

Mr. Chairman, it is important to understand the printing and publishing industry is comprised of several key segments. Publishers are those companies which publish periodicals, books, and other items but who do not own printing equipment. Newspaper publishers are those who both publish and print newspapers. The remainder of printing and publishing, or roughly half the total of the entire industry, is commercial printing and activities related to commercial printing. While these companies print books and magazines, they also print many newspaper inserts, newsletters, advertising materials, labels, forms, wedding invitations, and virtually every other item where an image is created on some type of surface.

Let me just spend a moment describing today's commercial printing industry. Commercial printing is the largest manufacturing industry in the Nation in terms of number of establishments. Over 42,000 firms generating $79 billion in sales employ more than 820,000 individuals. Unlike many U.S. manufacturers we have witnessed steady increases in productivity while watching employment and average wages increase as well. We also are a net exporter, having enjoyed a favorable balance of trade for many years.

Mr. Chairman, my comments today are directed toward item No. 2 under the cost recovery section of the August 17 press release which was a proposal to extend the recovery period applicable to certain assets used in printing and publishing to 10 years. As I understand the proposal, it would shift equipment which is today on a 7-year depreciation schedule, including press equipment, bindery equipment and certain prepress equipment such as electronic scanners, to a 10-year schedule.

I must tell you, in all honesty, that this proposal has been met with shock, disbelief and genuine outrage by an industry that is still climbing back to health after the recent recession. Because our industry is comprised of a high number of small family-owned enterprises, the most successful of which have already taken a hit this year from the recent reconciliation bill which increased the rates of subchapter S corporations, we are already concerned about generating the capital necessary to keep our plants up to date and competitive.

Printing is a capital-intensive industry that has been revolutionized in recent years by rapid changes in technology. Even the current 7-year depreciation schedule is often inadequate to allow for the full recovery of equipment investments. Stretching the depreciation schedule out to 10 years not only fails to take into account the reality of today's printing environment but it unfairly singles out our industry relative to other American manufacturers.

It used to be we kept a printing press for 8 to 10 years and only replaced it because it wore out. Today, however, we replace our equipment in 5 to 7 years, primarily because new technologies are constantly evolving. Investing in this new technology can give a printer a competitive edge in a particular market segment.

In view of the rapid changes in technology, any changes in the depreciation schedule for our industry should be geared toward reducing the term such as a 5-year schedule used in Germany rather than increasing the schedule far beyond the useful life of a product. However, we do not come to Congress to propose a shorter depreciation schedule. In fact, the commercial printing industry has never approached this committee for a tax break or a special program.

Instead, someone in Congress took it upon themselves to suggest a change in our depreciation solely based upon the need for increased Federal revenue rather than out of any interest to adjust the schedules to economic reality. If the proposal were part of a broad review of depreciation schedules for all industry, we would be happy to make our case for retaining the present schedules, but on this issue printing has been singled out as the only industry to take a direct hit, and the proposed changes have nothing to do with the actual use of equipment in our plants today.

Contrary to the predictions of many, the market for printed products is larger than ever and shows every indication of continuing steady growth well into the future. Remember the paperless office? If your office is anything like mine, it has more paper in it today than ever before. Yes, much of it is photocopied, but even with the tremendous growth in photocopying, demand for printing has continued to grow. Many predicted that the advent of the personal computer would mark the end of traditional printing, yet imagine a book store today without computer magazines and books and imagine your PC without volumes of software manuals and instruction material, all of it printed by our industry. The advent of the computer age has resulted in more printing, not less.

The greatest impact of these new technologies on printing has been the way the technologies themselves have been utilized in the printing process. The computer chip is now an integral part of almost every new piece of equipment in the industry. As new markets for printed material develop, competition for the latest press technology to enable a printer to maintain a competitive edge grows sharper.

At a time when this industry is growing at a rate faster than the gross national product and when we are enjoying a favorable trade balance, this committee should be taking steps to urge us to expand, not contract. In the name of the 42,000 small firms making up this industry, we urge you not to ask the printing industry to slow its growth solely for additional revenue.

Mr. Chairman, I have attached a chart on the next page which you have, I believe, which demonstrates the effect of the proposed change on printers of varying size.

I want to thank you for this opportunity to appear before you today. Thank you.

[The statement and attachment follow:]

STATEMENT OF HOWARD C. WEBBER, JR., ON BEHALF OF PRINTING INDUSTRIES OF AMERICA, AND GRAPHIC ARTS LEGISLATIVE COUNCIL

Mr. Chairman, members of the Subcommittee, my name is Howard C. Webber, and I am the chairman and chief executive officer of Cohber Press, Inc., a 58 employee commercial printing firm located in Rochester, New York. I am a former Chairman of the Board of Printing Industries of America, the largest printing and graphic arts trade association in the United States with over 14,000 member companies.

I am appearing before you today on behalf of the Graphic Arts Legislative Council (GALC), a group of national graphic arts associations formed in 1988 to provide a forum for addressing legislative and regulatory proposals before federal and state government. The Council consists of 14 associations representing every aspect of the printing and graphic arts industry.

Mr. Chairman, it is important to understand that the "printing and publishing industry" is comprised of several key segments. Publishers are those companies which publish periodicals, books, and other items but who do not own printing equipment. Newspaper publishers are those who both publish and print newspapers. The remainder of "printing and publishing," or roughly half the total of the entire industry, is commercial printing and activities related to commercial printing. While these companies print books and magazines, they also print many newspaper inserts, newsletters, advertising materials, labels, forms, wedding invitations, and virtually every other item where an image is created on some type of surface.

Let me spend a moment describing today's commercial printing industry. Commercial printing is the largest manufacturing industry in the nation in terms of numbers of establishments. Over 42,000 firms generating $79 billion in sales employ more than 820,000 individuals. Unlike many U.S. manufacturers, we have witnessed steady increases in productivity while watching employment and average wages increase as well. We are also a net exporter, having enjoyed a favorable balance of trade for many years.

Mr. Chairman, my comments today are directed toward item number 2 under the cost recovery section of the August 17 press release which was "a proposal to extend the recovery period applicable to certain assets used in printing and publishing to 10 years." As I understand this proposal, it would shift equipment which is today on a 7 year depreciation schedule, including press equipment, bindery equipment and certain prepress equipment such as electronic scanners to a 10 year schedule.

I must tell you in all honesty, that this proposal has been met with shock, disbelief, and genuine outrage by an industry that is still climbing back to health after the recent recession. Because our industry is comprised of a high number of small family-owned enterprises, the most successful of which have already taken a hit this year from the recent reconciliation bill which increased the rates on Subchapter S corporations. We are already concerned about generating the capital necessary to keep our plants up to date and competitive.

Printing is a capital intensive industry that has been revolutionized in recent years by rapid changes in technology. Even the current 7-year depreciation schedule is often inadequate to allow for the full recovery of equipment investments. Stretching the depreciation period out to 10 years not only fails to take into account the reality of today's printing environment, but it unfairly singles out our industry relative to other American manufacturers.

It used to be that we kept a printing press for 8-10 years and only replaced it because it wore out. Today, however, we replace our equipment in 5-7 years primarily because new technologies are constantly evolving. Investing in this new technology can give a printer a competitive edge in a particular market segment. In view of the rapid changes in technology, any changes in the depreciation schedule for our industry should be geared toward reducing the term, such as the five year schedule used in Germany, rather than increasing the schedule far beyond the useful life of a product.

However, we did not come to Congress to propose a shorter depreciation schedule. In fact, the commercial printing industry has never approached this committee for a tax break or special program. Instead someone in Congress took it upon themselves to suggest a change in our depreciation solely based on the need for increased federal revenue rather than out of any interest to adjust the schedules to economic reality. If the proposal were part of a broad review of depreciation schedules for all industry, we would be happy to make our case for retaining the present schedules. But on this issue, printing has been singled out as the only industry to take a direct hit and the proposed changes have nothing to do with the actual use of equipment in our plants today.

Contrary to the predictions of many, the market for printed products is larger than ever, and shows every indication of continuing steady growth well into the future. Remember the "paperless office?" If your office is anything like mine, it has more paper in it today than ever before. Yes, much of it is photocopied. But even with the tremendous growth in photocopying, demand for printing has continued to grow. Many predicted that the advent of the personal computer would mark the end of traditional printing. Yet imagine a bookstore today without computer related magazines and books and imagine your PC without volumes of software manuals and instructional material, all of it printed by our industry. The advent of the computer age has resulted in more printing, not less.

The greatest impact of these new technologies on printing has been the way the technologies themselves have been utilized in the printing process. The computer chip is now an integral part of almost every new piece of equipment in the industry. As new markets for printed material develop, competition for the latest press technology to enable a printer to maintain a competitive edge grows sharper.

At a time when this industry is growing at a rate faster than the Gross National Product and when we are enjoying a favorable trade balance, this committee should be taking steps to urge us to expand, not contract. In the name of the 42,000 small firms making up this industry, we urge you not to ask the printing industry to slow its growth solely for additional revenue.

Mr. Chairman, I have attached a chart on the next page which demonstrates the effect of the proposed change on printers of varying size. I want to thank you for this opportunity to appear before you today.

Members of the Graphic Arts Legislative Council include: Book Manufacturers' Institute, Inc., Envelope Manufacturers Association of America, Flexographic Technical Association, Inc., Foil Stamping and Embossing Association, International Association of Diecutting and Diemaking, International Prepress Association, International Reprographic Association, National Association of Printers and Lithographers, National Association of Printing Ink Manufacturers, Inc., National Association of Quick Printers, Inc., North American Graphic Arts Suppliers Association, Printing Industries of America, Inc., Research and Engineering Council of the Graphic Arts Industry, Inc. and Typographers International Association.

Mr. Howard C. Webber, Jr.
Cohber Press, Inc.
1000 John Street
P.O. Box 93100
Rochester, NY 14692
(716) 475-9100

Graphics Arts Legislative Council
c/o Printing Industries of America
100 Daingerfield Road
Alexandria, VA 22314
Contact: Benjamin Y. Cooper
(703) 519-8158

Effect of 7 Versus 10 Year Recovery Period (Depreciation)
August 31, 1993

Company Sales Volume	Cost of Asset Acquisition	10 Year Depreciation	7 Year Depreciation	Difference	Additional Taxes Due*
$2,000,000	$ 300,000	$ 30,000	$ 42,870	$ 12,870	$ 5,019
$5,000,000	750,000	75,000	107,175	32,175	12,548
$10,000,000	2,000,000	200,000	285,800	85,800	33,462
Over $20,000,000	5,000,000	500,000	714,500	214,500	83,655

** Assumes that the printing company is a C corporation in the 39% tax bracket (effective 1/1/93), i.e. taxable income between $100,000 and $335,000.*

Mr. PAYNE. Thank you, Mr. Webber.

Our last witness, representing the Association for Suppliers of Printing and Publishing Technologies, is Mark Nuzzaco, director of government affairs.

STATEMENT OF MARK J. NUZZACO, DIRECTOR OF GOVERNMENT AFFAIRS, NPES, THE ASSOCIATION FOR SUPPLIERS OF PRINTING AND PUBLISHING TECHNOLOGIES

Mr. NUZZACO. Thank you. Good afternoon. My name is Mark Nuzzaco. I am director of government affairs for NPES, the Association for Suppliers of Printing and Publishing Technologies.

We thank the chairman and subcommittee for the opportunity of appearing before the subcommittee to comment on a proposed change in the tax law extending to 10 years the recovery period for certain assets used in printing and publishing. We feel that such a change would be very detrimental to the economic recovery and long-term vitality of our industry and our customers.

My full statement, which has been submitted for the record, elaborates on our opposition to this proposal. For purposes of today's hearing, I will summarize our concerns.

Before beginning my comments, I would like to acknowledge that I am pleased to share the witness table today with Mr. Webber, chairman of Cohber Press, Rochester, N.Y., representing our sister association, Printing Industries of America, which is comprised of thousands of our members' customers, and the Graphics Arts Legislative Council. In light of the subcommittee's full agenda, my remarks are intended to complement Mr. Webber's testimony.

NPES represents approximately 300 companies which account for about 90 percent of domestic production of printing and publishing technology. Nearly 60 percent of NPES's members are small businesses with gross sales of $5 million or less.

The printing and publishing technologies industry provides an enormous variety of products and supplies to meet the needs of the printing and publishing industry and its many segments. It is an arena in which societal trends, fast-moving technology and intense competition are all helping to shape the future.

The most obvious of the assets used in this industry, printing presses, represent just one stage in the long and technically complex task of transforming ideas into printed materials. However, many other technologically sophisticated products are also employed in the industry.

The total market for printing equipment in 1992 approached $2.1 billion in orders and was slightly over $2.1 billion in product shipments. The relatively modest size of the printing and publishing technologies industry belies its critical role in supporting the much larger, crucially important graphics communication industry that has been described by Mr. Webber.

Until just a few years ago, most information was disseminated by publications that were printed by one of four major printing processes. Today, however, we are witnessing a broad expansion of communicational alternatives, largely based on rapidly changing technologies.

The proposal to extend to 10 years the recovery period for certain assets used in printing and publishing is detrimental to the graphic communication industry's need for improved quality and productivity. Currently, assets used in printing and publishing are defined to have an 11-year class life and are in the 7-year modified accelerated cost recovery system class for depreciation. These assets would include printing presses and machinery used in the bindery.

In light of the new technological changes to this traditional equipment, even the current 7-year depreciation period exceeds the commercial life of much of this machinery. Extending the capital cost recovery period by nearly another 50 percent to 10 years would clearly be the wrong policy to adopt at a critical point in the industry's recovery from the economic downturn we have just endured.

Historically, the industry has had an electromechanical orientation. However, in 1979 the technological revolution began in the graphics arts industry with introduction of the color electronic prepress system. With this product computers were introduced to the printing process, and that change more than any other caused a fundamental change in the printing and publishing industry. Before this era in the mid 1970s, printing press speeds were just one-third of today's top speeds of over 3,000 feet per minute. It took 10 years to increase from 1,000 to 1,500 feet per minute. But speeds have doubled to over 3,000 feet per minute in just the last 7 years.

Clearly, the rate of change is increasing dramatically. At such speeds, computerized controls were required.

At the same time, the 1980s witnessed the color revolution in the printing and publishing industry. Advertisers demanded more and higher quality color. This color revolution fueled rapid growth in the printing market and demanded new and more sophisticated technology.

As rapidly as press technology is changing, innovation in the prepress area is occurring even faster. The conversion from analog to digital data use is an underlying cause of the change. This transition is forcing vendors to focus on the development and sale of discreet products that can be indiscriminately interchanged by the user.

This situation is similar to what has already happened in the electronic office environment. As we have continued to see in the "plug and play" environment of the electronic office, standards-based prepress products will also require more frequent revision and/or replacement, thus requiring routine upgrade to stay competitive.

As long as printers have been putting ink to paper, the quest for greater output and better quality with fewer man hours and reduced waste has been the driving force for every press manufacturer. Today's technologies have taken this quest to even a new level. Today's increasingly rapid, technological advances are yielding faster production speeds, quicker make-readies, reduced running and make-ready waste, better flexibility and quality over a range of jobs, less downtime and, more importantly, the ability to compete better with other communications vehicles.

New orders for printing equipment are expected to rise 12 percent this year and 6 percent in 1994. Shipments of imaging and prepress equipment systems, in essence, computers and the software needed to run them, are expected to rise about 10 percent this year and 8 percent in 1994. While these are respectable gains, they lag far behind the 15 to 20 percent growth rates of the computer industry generally. This is because the technological revolution is incompletely implemented in the printing industry because of a lack of cash flow and ability to borrow, especially by smaller printing companies.

Capital spending, after getting off to a good start in the first quarter, abruptly reversed course when the Clinton administration announced it would not reinstate the investment tax credit after all. Although the provision of the Omnibus Budget Reconciliation Act of 1993 increasing the expenses deduction for small businesses from $10,000 to $17,500 is helpful, its incentive for investment will be severely eroded by the extension of the depreciation period to 10 years as called for in this proposal.

Rather than impeding investment, especially productivity-improving capital expenditures by small businesses, Congress should be looking for ways to encourage capital formation and investment in new technologies necessary for a revitalized industrial infrastructure.

Mr. Chairman, we respectfully urge you to adopt such a course, and reject the current proposal. We thank you for the opportunity to present these comments. I would be pleased to answer any questions or submit additional information for the record.

Thank you.

[The prepared statement follows:]

STATEMENT BY

MARK J. NUZZACO

DIRECTOR OF GOVERNMENT AFFAIRS

NPES THE ASSOCIATION FOR SUPPLIERS OF PRINTING AND PUBLISHING TECHNOLOGIES

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES OF THE COMMITTEE ON WAYS AND MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

SEPTEMBER 8, 1993

I. INTRODUCTION

Good Morning. My name is Mark J. Nuzzaco. I am Director of Government Affairs for NPES The Association for Suppliers of Printing and Publishing Technologies. I am here today representing the thousands of women and men who comprise a basic industry that is part of our nation's industrial backbone. On their behalf I thank you Mr. Chairman for the opportunity of appearing before the Subcommittee on Select Revenue Measures to comment on a proposed change in the tax law extending to ten years the recovery period for certain assets used in printing and publishing. We feel that such a change would be very detrimental to the economic recovery and long-term vitality of our industry. My full statement, which has been submitted for the record, elaborates on our opposition to this proposal. For the purpose of today's hearing I will summarize our concerns.

Before beginning my comments, I would also like to acknowledge that I am pleased to share the witness table today with Mr. Howard C. Webber, Jr., President, Cohber Press, Rochester, N.Y., representing our sister association Printing Industries of America, which is comprised of thousands of our members' customers, and the Graphic Arts Legislative Council. In light of the Subcommittee's full agenda, my remarks are intended to compliment Mr. Webber's testimony.

A. NPES The Association for Suppliers of Printing and Publishing Technologies

NPES The Association for Suppliers of Printing and Publishing Technologies is a national trade association whose member companies are engaged, within the United States, in building, manufacturing, repairing, selling, importing for sale, or distributing printing and publishing technologies used in the graphic communications industries. NPES membership currently stands at approximately 300 companies which account for about 90% of domestic production of printing and publishing technologies. Nearly 60% of NPES members are small businesses with gross sales of $5 million or less annually.

B. The Printing and Publishing Technologies Industry

America's graphic communications industry requires an enormous variety of products to do its work. The printing and publishing technologies industry provides the products and supplies that meet the needs of the printing and publishing industry and its many segments. These segments include commercial printing, corporate publishing, magazines and periodicals, newspapers, book printing and publishing, business forms, packaging, specialty printing, trade services, graphic design houses, advertising agencies and desktop publishers using lithographic, letterpress, flexographic, gravure, screen, and non-impact processes. It is an arena in which societal trends, fast-moving technology, and intense competition are all helping to shape the future.

The most obvious of the assets used in this industry, printing presses, represent just one stage in the long and technically complex task of transforming ideas into printed materials. Every printing job, from the simplest to the most elaborate, goes through the same basic processes: prepress, press, and bindery.

The products employed in the printing industry include typesetting systems, page composition systems, negative and plate-making equipment, presses of all types, press accessories and binding and finishing apparatus. Printing supplies include papers, films, plates, and chemicals for photo typesetting and other prepress functions.

Printing Trades Machinery (SIC 3555) is identifiable as a discrete category within the more general classification of Special Industry Machinery of the Department of Commerce's Standard Industrial Classifications System (SIC). The total market for printing equipment in 1992 approached $2.1 billion in orders and was over $2.1 billion in product shipments.

The graphics arts supplies portion of the industry is less readily identified, as these products typically are not aggregated as a separate group, but are spread across several broader industry categories, such as chemicals and photographic supplies.

C. America's Graphic Communications Industry

The relatively modest size of the printing and publishing technologies industry belies its critical role in supporting the much larger, crucially important graphic communications industry. With establishments in virtually every town and county, products of the U.S. printing and publishing industry serve the country's diverse communication needs. According to the 1992 Census of Manufacturers, of the 20 major manufacturing groups included in the SIC, printing and publishing ranks third in the number of establishments. There are more than 60,000 printing establishments nationwide, employing some 1.55 million people.

Until just a few years ago most publications were printed by one of the four major printing processes (offset lithography, gravure, flexography, and letterpress). That being the case, the industry's users, vendors, technologies and products were focused on the printing process and meeting its requirements.

Today, however, we are witnessing a significant industry refocus from printing to publishing, which will also include the broad world of communications by later in the decade. As a result, in addition to printing, many of the same publications may be: 1) reproduced by a xerographic electronic publishing system; 2) provided as an electronic database (for example: airline scheduling, legal records, etc.); and/or 3) distributed on magnetic media (for example: CD-ROM). This "non-traditional" focus represents a substantial shift in the industry's perspective, made possible due to a wide range of factors. This broad expansion of communication alternatives, largely based on rapidly changing technologies, offers both major challenges and opportunities for traditional printers and their suppliers.

II. THE PROPOSAL TO EXTEND TO TEN YEARS THE RECOVERY PERIOD FOR CERTAIN ASSETS USED IN PRINTING AND PUBLISHING IS DETRIMENTAL TO THE GRAPHIC COMMUNICATION INDUSTRY'S NEED FOR IMPROVED QUALITY AND PRODUCTIVITY

Currently, assets used in printing and publishing are defined to have an 11 year class life and are in the 7-year MACRS class for depreciation. These assets would include printing presses, and machinery used in the bindery. In light of the new technological changes to this traditional equipment, even the current 7-year depreciation period exceeds the commercial life of most of this machinery. Extending the capital cost recovery period by nearly another 50% to ten years would clearly be the wrong policy to adopt at a critical point in the industry's recovery from the economic downturn we have just endured. To help put this in context, let me tell you about the rapidly changing nature of the technology at issue.

A. Printing and Publishing and the Increasingly Competitive Communications Market

There are a number of trends shaping the outlook for the printing and publishing industry. A major factor is the impact of electronic technologies on the use of printing materials. In entertainment we have interactive video. In advertising we have multi-media and cable TV. In the business marketplace we have digital technologies, multi-media and interactive video. The same products impact the education and research arena. Not long ago print was the sole domain of communication. Then came radio, TV, cable and today we have multi-media, digital data bases, CD Rom and other technologies that all compete with printing and publishing.

B. The Eighties - A Decade of Rapid Technological Change

The printing and publishing industry is a bit of a paradox. It is an old, mature industry on the one hand. But on the other hand, it's an industry facing rapid technological change mainly due to the adoption of computer technology to a craft-oriented process.

Historically, the industry has had an electromechanical orientation. Phototypesetting was the predominant way to prepare text for printing. Graphic arts cameras and, to a certain degree, analog scanners were in use to digitize photographic images for printing. However in 1979 a company called Scitex launched a new product, the color electronic prepress system and began a technological revolution in the graphic arts industry. With this product, computers were introduced to the printing process and that change, more than any other, caused a fundamental change in the printing and publishing industry. In addition to the introduction of the color electronic prepress system, a number of other major innovations happened in the 1980's that had a dramatic impact on the industry.

Before this era, in the mid-1970's printing press speeds were just one-third of today's top speeds of over 3,000 feet per minute. It took ten years to increase from 1,000 to 1,500 feet per minute. But speeds have doubled to over 3,000 feet per minute in just the last seven years. Clearly, the rate of change is increasing dramatically. At such speeds, computerized controls were required so that register was maintained throughout the run length and that quality could be insured from impression #1 to the final impression on the job. Automation of press equipment was the means that allowed these increased press speeds. Similarly, automation in the bindery improved the throughput, so that the entire printing process from "cradle to grave" was much faster, efficient and reliable.

Two other product introductions in the mid 1980's continued the rapid revolution in the printing industry: the laser printer and Postscript. These two introductions changed the way images and text were prepared for printing. In combination with a software program by Aldus Corporation entitled PageMaker, these low-end (inexpensive) systems allowed a whole new group of individuals to create pages and become involved in the printing and publishing process. This phenomenon was called desktop publishing by Paul Brainerd, the founder of Aldus.

At the same time the 80's witnessed a color revolution in the printing and publishing industry. Advertisers demanded more and higher quality color. The notion that color sells became the dominant theme in the marketing of products. In order to compete with network TV, cable TV and other media, printers had to produce higher quality color on a consistent basis. In addition, the launching of **USA Today** by the Gannett Corporation brought color into everyone's home or office on a daily basis.

This color revolution fueled rapid growth in the printing market, and demanded new and more sophisticated technology. One and two color presses were no longer the norm. Four, five, six, seven and in some cases eight-color printing presses were purchased by printers all over the country. At the same time the sophisticated digital prepress equipment required to reproduce these quality color pages was purchased by color trade shops and certain printers and publishers. So the 1980's began an era of tremendous technological change which continues today.

The fact of the matter is that the printing industry is evolving from a craft orientation to a technology orientation at an alarming pace. In a little over 10 years, the industry has gone from a completely photomechanical and electromechanical orientation to one where digital technology touches all aspects of the process from design through printing through binding finishing and distribution.

C. The Impact of Changing Prepress Technology

As rapidly as press technology is changing, innovation in the prepress area is occurring even faster. A major reason for this is the expanding role that prepress is having on information processing and dissemination and resulting new market opportunities that encompass the broader worlds of publishing and communications.

The conversion from analog to digital data usage is an underlying cause of prepress change. For decades photographic materials have been the analog prepress standard. They have enabled users to merge discrete elements, from virtually any origin, into a final page for platemaking. Generally speaking, digital products have not been able to provide this standard environment to date.

However, with the development of industry standards and the evolution of products that function within a common environment, digital standardization will occur between now and the year 2000, and be adopted by the major prepress service suppliers. The adoption of digital standardization is also a basic requirement for expanding the scope of the prepress market into Computer-Based-Publishing and communications market applications.

The transition to a digital environment will result in manual operations being replaced. The transition to a digital standard will have a significant effect on the use of certain types of traditional equipment and supplies. Ultimately the analog-to digital transition will result in new hardware, software, supplies, and support needs.

Standardization will challenge product development. First, products will increasingly become interchangeable. The transition will force vendors to focus on the development and sale of discrete products that can be indiscriminately interchanged by the user. This situation is similar to what has happened in the electronic office environment.

Compounding the product differentiation challenge is the issue of product life cycle. As we have continued to see in the "plug and play" environment of the electronic office, standards-based prepress products will also require more frequent revision and/or replacement, thus the need to routinely upgrade to stay competitive.

D. The Benefits of Advanced Technologies

For as long as printers have been putting ink to paper, the quest for greater output and better quality with fewer man hours and reduced waste has been the driving force for every press manufacturer. Today's new technologies have taken this quest to a new level.

Take for example one manufacturer's development of the continuous tubular blanket sleeve which slides onto the blanket cylinder through the side frame of the press, thereby reducing the plate cylinder gap to a mere 1/16 inch. The result is economic and environmental benefits due to significant paper savings as a result of the elimination of the blanket gap's non-print area. This and other increasingly rapid technological advances are yielding faster production speeds, quicker makereadies, reduced running and makeready waste, better flexibility and quality over a range of jobs, less downtime, and most importantly - the ability to better compete with other communication vehicles.

E. The Challenge to Capital Investment in Printing and Publishing Technologies

The NPES Quarterly Economic Forecast, prepared by NPES consulting economist, Michael K. Evans, reviews the general economic outlook, printing and publishing equipment ordered and supplies shipments. The forecast is derived from an econometric model developed by Evans for NPES. Based on this model, new orders for printing equipment are expected to rise 12% this year and 6% in 1994. Most of the growth probably occurred in the first half of the year, when prospects for economic growth seemed brighter and many expected the investment tax credit to be reinstated. Although interest rates will remain low, this has little effect on capital spending during a period when capacity utilization rates are low and many smaller firms are denied access to credit markets.

Shipments of imaging and prepress equipment systems, in essence computers and the software needed to run them, are expected to rise about 10% this year and 8% in 1994. While these are respectable gains, they lag far behind the 15% to 20% growth rates of the computer industry generally. The technological revolution is incompletely implemented in the printing industry because of a lack of cash flow and ability to borrow, especially by smaller printing companies.

Capital spending, after getting off to a sparkling start in the first quarter, abruptly reversed course when the Clinton Administration announced it would not reinstate the investment tax credit after all. Thus the combination of insufficient cash flow and weak demand for customized printing will keep the growth in shipments of imaging and prepress equipment at moderate rates, in spite of the continuing computer revolution.

Although the provision in the "Omnibus Budget Reconciliation Act of 1993" increasing the expensing deduction for small businesses from $10,000 to $17,500 during the year that the property is purchased is helpful, its incentive for investment will be severely eroded by the extension of the depreciation period to ten years as called for in this proposal. Clearly, Congress would be double-minded to adopt such a policy.

CONCLUSION

Rather than impeding investment, especially capital expenditures by small businesses, Congress should be looking for ways to encourage capital formation and investment in new technologies necessary for a revitalized industrial infrastructure. Mr. Chairman, we respectfully urge you to adopt such a course, and thank you for the opportunity to present these comments. I would be pleased to answer any questions or submit additional information for the record.

Mr. PAYNE. Thank you, Mr. Nuzzaco.

Mr. Hancock.

Mr. HANCOCK. Thank you, Mr. Chairman.

Question for Mr. Nuzzaco or Mr. Webber. We have two situations here we are talking about. One is a change in the depreciation schedule on printing equipment. Another one is the change in the deduction for advertising. Which one of those two will impact you the most?

One of them is likely to put you out of business. What will the two of them do to you?

Mr. WEBBER. I wouldn't like either of them, but I am certain the change in advertising would be extremely harmful to the printing industry, too, which relies heavily on the advertising industry.

Mr. HANCOCK. Do you estimate in your own mind that requiring advertising amortization would be even more serious to the printing industry than the change in depreciation?

Mr. WEBBER. Yes, sir, it would be.

Mr. HANCOCK. Thank you very much.

Mr. WEBBER. But they both would be harmful.

Mr. HANCOCK. I don't know if you are aware of it or not, but a few months ago—in fact, you might want to look it up—I think it was in Reader's Digest, there was quite an article about who the millionaires really are. It ended up saying that the millionaires are people that most people don't know are millionaires; they are people that work 60, 70, 80 hours a week; they are married; they are roughly 55 years old, been married one time, and the majority of them own printing plants. I thought it was interesting.

I am quite familiar with the printing industry. Let's face it, you have to pump so much money back in for equipment in the printing industry that if you can stay in it and compete, you will end up with a pretty substantial investment in equipment.

Printing equipment, incidentally, is also one of our major exports. King Press down in my district recently shipped overseas some web press equipment.

[The following was subsequently received:]

NPES The Association for Suppliers of
Printing and Publishing Technologies
1933—60 *Years of Service*—1993

September 14, 1993

The Honorable Mel D. Hancock
U.S. House of Representatives
Washington, DC 20515

Dear Congressman Hancock:

I am writing to supplement formal testimony given by me on behalf of NPES The Association for Suppliers of Printing and Publishing Technologies before the House Ways and Means Subcommittee on Select Revenue Measures on September 8, 1993. I was a member of panel number four that day, and spoke in opposition to the proposal to extend to ten years the recovery period for certain assets used in printing and publishing. A copy of my full statement is enclosed with this letter.

For the record I would like to respond to a question you posed to me and another witness on the panel, Mr. Howard C. Webber, Chairman, Cohber Press, Rochester, N.Y., representing Printing Industries of America and the Graphic Arts Legislative Council. Specifically, you asked whether in general printers would be more affected by the proposed lengthening of the period for depreciating equipment used in printing and publishing, or by a proposal to require that a portion of advertising expenses be capitalized and amortized over a period of years rather than treated as a business deduction as under current law.

When asked to assess the relative affects of two detrimental proposals, Mr. Webber candidly, and I think accurately from the point of view of most printers, responded by saying that the proposal to capitalize advertising expense would have a more detrimental affect on printers' businesses than the lengthening of depreciation from seven to ten years on printing equipment. Although I did not respond to your question during the hearing, I would like to submit the following comments, with the request that they be inserted at the appropriate place in the hearing record.

As you will note, both my testimony and Mr. Webber's is directed solely and specifically to the proposal to extend to ten years the capital cost recovery period for assets used in printing and publishing. As manufacturers and consumers of this equipment, we of course have a particularly keen interest in this narrowly drawn proposal that directly targets our businesses. At the same time, however, we also have a special concern about the method by which advertising expenses are treated for tax calculations, due to the fact that significant portions of many printers' incomes are derived from the printing of advertising. While in aggregate terms the proposed change in the treatment of advertising expenses would by comparison to lengthening depreciation have a significantly greater impact on the economy as a whole, and most printers in particular, neither proposal is desirable by itself, and if combined would be terribly detrimental to the economic interests of printers and their suppliers.

To carry the analysis further, while each of the two proposals would have a negative impact on printers and their suppliers, this impact would affect their businesses in different ways. For example, requiring advertising expenses to be capitalized and amortized would undoubtedly have a chilling effect on the total market for advertising, as the cost of such activity becomes greater. In other words, the economic pie of advertising revenue would be diminished as the activity becomes relatively more expensive. The statements of many other witnesses in opposition to this proposal is testament to the wide spread negative effect of such a proposal.

On the other hand, the lengthening of depreciation has more to do with printing and publishing's ability to compete for a slice of the advertising revenue pie. In a market that is already challenging printers to stretch to remain technologically competitive, the additional competitive disadvantage of lengthening depreciation would make it even more difficult for printing and publishing to compete for a share of the market for information dissemination vis-a-vis other modes of communication.

To complete my response to your question, let me carry the analysis one final step. Any reduction in the printing and publishing industry's ability to upgrade its technology will have a negative effect on the printing and publishing equipment supply industry, regardless of the cause of that reduction. And to the extent that these suppliers' businesses decline, the very existence of those at the margin may be jeopardized while many others are weakened, resulting in the loss of good paying manufacturing jobs.

Moreover, another indirect consequence of such a decline which may not immediately come to mind, but to which you alluded in your comments during the hearing, is the fact that exports of printing and publishing equipment have been up during the domestic economic slowdown we have been enduring. As you noted at the time of the hearing, King Press Corporation, located in your congressional district in Missouri, is an excellent example of a capital goods manufacturer that has excelled in exporting to the extent of being named Missouri Exporter of the Year. For example, in recent times over 65 percent of its product has been exported. Capital goods manufacturers will not be able to seize such opportunities unless they are economically viable and ready to compete for this business. Policies that foster such commercial readiness are in the economic best interest of the country and should be encouraged, not impeded by government policy, especially policy such as the current proposal to extend depreciation for assets used in printing and publishing, that singles out specific industry to its detriment.

On behalf of NPES and myself, I appreciated the opportunity to testify before you and the other members of the Subcommittee, and hope that this letter serves to further explain our opposition to the lengthening of depreciation on assets used in printing and publishing, as well as the proposal to capitalize advertising expenses.

I would be pleased to respond further on these issues if necessary.

Sincerely,

Mark J. Nuzzaco
Director of Government Affairs

Enclosure

cc: Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives

Ben Cooper
Regis J. Delmontagne
James C. Gould
A.J. Hall
J.M. Mike Murray
John M. Nannes
Howard C. Webber, Jr.

Mr. Cohen and Mr. Feeney, how many jobs will be affected by this change in the advertising deduction in your judgment? I realize we are not going to get any real actuarial or GAO accounting or OMB studies or anything like that.

Mr. COHEN. Well, it is very difficult to judge. The costs will go up, the cost of advertising will go up. Therefore, budgets will go down. So there will be less advertising, there will be less printing, there will be less newspaper ads and so forth, and it should—I mean, if logic follows, it should reduce sales because people advertise to sell things, and if you have less information, there will be less purchasers right there.

So it is going to have a dramatic effect, but it is way down the pike. It takes a long time for that to feed through the system, but it is deleterious to the system obviously.

Mr. HANCOCK. This idea of getting rid of deductions started way back many years ago when all of a sudden the Government decided, well, it can't raise rates past 50 percent, so therefore it is going to start getting rid of deductions. Well, you can't fully deduct the cost of meals and entertainment expenses.

I happen to be a small businessman. I know the benefit of taking somebody out to lunch once in a while. In fact, I probably have closed more contracts at luncheon meetings than any other time. So they cut back on that deduction.

Now they are going to reduce it to 50 percent. Now they are talking about cutting back the advertising deduction. Here again, the business lunch is a little bit of an advertising.

Now my question is, and here again in generalities, are we heading toward a gross receipts tax rather than an income tax? You know, just taxing gross sales? Is that where we are going?

Mr. FEENEY. Hopefully not.

Mr. HANCOCK. Wouldn't it appear that this is the route we are taking? You take advertising. You say, OK, you can't deduct 20 percent. Now 3 years from now we will say, well, you can't deduct 50 percent. If we keep doing this, there isn't going to be anybody left to tax.

Mr. COHEN. The problem is really more the complications in accounting. That is as you add one more job for the internal accountant in the company to take on, and his external accountant, the CPA to take on, you add the costs there and of course you add—when these proposals are suggested, nobody thinks about the fact it is one more job for the revenue agent to do. That is, the revenue agent now takes a look to see whether the advertising costs or other costs are legitimate, but once he has done that, that is the end of it. But there would be a new purpose now, he would have to list those which are going to be subject to this amortization, whatever that definition might be, and that is a problem, and then he has to subject them to the amortization schedule, and then he has to go back and audit last year's amortization schedule to see that you are carrying forward the right numbers, so you have add infinitely more complexity out of this one little change.

Every time you do it, as you indicated, Mr. Hancock, every time you do it, you add that much more complexity on top of an already existing complex system.

Mr. HANCOCK. I am having trouble finding out or determining just what is advertising. Has anybody really defined it? Are we talking about radio and television? We talk about newspapers, we talk about magazines. Are we talking about Yellow Pages advertising? Are we talking about handout pieces? Are we talking about a PR employee, a guy who goes out to solicit business, not a salesman? Is that advertising? What is advertising?

Mr. COHEN. Your committee is going to have to define that. If you were to adopt this rule, which all of us have opposed, if you were to adopt it, you will have to adopt a definition of whether the promotional man who goes out and calls on people, is he advertising? You know, are the people who prepare materials within the company to supply information to the advertising agency, each of those would require definition. And whoever is going to draft this, you or your staff, are going to have to think those problems through, because otherwise you are going to leave it to a regulation writer. I used to be a regulation writer once in the Revenue Service and I also used to be a regulation signer once in the Revenue Service. Otherwise, you are going to leave those problems to those people and they don't want to do that either. They would rather you define them.

Mr. HANCOCK. What about amortizing election campaign advertising. That makes good sense, doesn't it?

Mr. COHEN. We disallowed that many years ago, sir.

Mr. HANCOCK. Maybe we ought to look into that, Mr. Chairman, as part of campaign reform. You have got to declare your contributions as income and then amortize the advertising. I don't know who came up with this, but I know this, that they are completely illogical. It absolutely does not make sense to do this to a business. As a small businessman, and I don't spend money on advertising just for the fun of it or just to see my name, because my company's name is not my name. That is not the reason we advertise. We advertise to generate profit, therefore to expand, therefore to employ more people. And advertising to me is the lifeblood of a lot of small businesses, especially the business that has a new idea, something that the public will buy if in fact they hear about it. Then we tell them that they have to amortize advertising or that it is not a deductible business expense. Even the legal profession is starting to advertise now. They are finding out that it is a benefit to them.

Anyway, Mr. Chairman, I strongly recommend that this committee do whatever we have got to do to let the business community advertise their products. If we don't advertise American products, I will bet that the Japanese and the Germans and others are going to advertise their products, and then what happens? There is nothing we can do about that.

Thank you, Mr. Chairman.

Mr. PAYNE. Mr. Hoagland will inquire.

Mr. HOAGLAND. I have no questions.

Mr. PAYNE. Mr. Camp.

Mr. CAMP. No questions.

Mr. PAYNE. I had just a question for Mr. Webber. Could you give us a description of the kinds of equipment that are being considered in this proposed legislation and the cost of that equipment?

Mr. **WEBBER**. Yes, Mr. Chairman. On the prepress area, you are probably talking scanners and equipment that you can start buying for $4,000, could probably go up to $150,000, $200,000. In the press area, you are talking probably small presses starting at $6,000, $7,000, $8,000, going up to your larger sheet-fed presses at $1.8 million, then into your web presses probably, what, $4 million or on up.

In the bindery area, again you can start with small folders at $5,000, $6,000, and go up to stitcher trimmers at $200,000, $250,000, all the way up to $1 million. For example, a company like ourselves, a $10 million company, our presses cost anywhere in the realm of $40,000 up to $1.8 million. And we sit right now, and I don't want to elaborate, but with a bank that based upon a 5-year pay back to the bank, and I don't know what we would do if we went to 10 years. They won't even let us go to 7 years.

Mr. **PAYNE**. How long do these assets typically last in the printing industry?

Mr. **WEBBER**. I think back in the 1970s and 1980s, they used to last probably 10 years, and it was probably an active thing. Right now, some of our prepress equipment we are buying, we are looking at an 18-month to 3-year payback because by then it is going to be obsolete, and in the printing press area we are probably looking at 5 to 6 years we hope to replace our equipment, again because of obsolescence, not because it wears out, but because something new and better comes on the market.

Mr. **PAYNE**. With your scanner equipment?

Mr. **WEBBER**. Scanner equipment. For example, now the big scanners that were bought for $200-, $250,000, are being replaced by desk top scanners costing $45,000 that are no bigger than that. So probably, I would say scanners probably 3 to 5 years max.

Mr. **PAYNE**. Thank you very much.

I would like to thank this panel for their testimony and for putting this information into the record. It will be very useful for the subcommittee and for the full committee.

Mr. **PAYNE**. Our next panel will testify concerning the increased tariff on imported crude oil and the increased tariff on refined petroleum products, and we will also have a witness testifying regarding a severance tax on hard rock mineral.

The first witness represents the Independent Refiners Coalition, Robert H. Campbell, president and chief executive officer and chairman of the Sun Co., Inc., Philadelphia, Pa.

Mr. Campbell, if you would proceed under the 5-minute rule. Thank you.

STATEMENT OF ROBERT H. CAMPBELL, PRESIDENT, CHIEF EXECUTIVE OFFICER AND CHAIRMAN, SUN CO., INC., ON BEHALF OF THE INDEPENDENT REFINERS COALITION

Mr. **CAMPBELL**. Thank you, Mr. Chairman and members of the committee. As you indicated, my name is Robert Campbell, and I am chairman, president, and chief executive officer of the Sun Co., which as you probably know is a 107-year-old oil company that is headquartered in Philadelphia. Philadelphia also happens to be the home of the first-place Philadelphia Phillies, and the expected site, beginning 4 weeks from today, of the National League baseball playoffs which will determine who gets to compete in this year's World Series.

I am here today to address a world series of another kind. This is a series involving our Nation's gasoline production industry, thousands of American jobs, our commitment to the environment, and our national security.

You know, when the Phillies take the field on October 7 they will do so knowing that their opponents will face the same rules that they do: The bases are going to be 90 feet apart for both teams and the pitcher's mound is going to be 60 feet, 6 inches from home plate, again for both teams. They are going to go into that game confident that ability will determine the outcome. Today, I am here seeking that same kind of competitive fairness for this country's independent refiners.

My written testimony that accompanies these remarks spells out the background information that I think you will find useful. It will tell you that the Sun Co. is a member of the Independent Refiners Coalition, and those are U.S. oil companies that have little or no crude oil production. We simply purchase crude oil, refine it into products, and supply the U.S. economy.

The written testimony will also tell you that 70 independent refining companies operate 140 refineries in 34 States. We employ 200,000 people, and they produce nearly 40 percent of the gasoline purchased in the United States today.

It will tell you that independent refiners have made and are continuing to make enormous expenditures to fulfill their environmental obligations. Those expenditures fall into two categories. The first is the investment in new processing equipment to produce the new, cleaner burning fuels. The second is the investment in our refineries, pipelines and terminals to eliminate air, water, and soil contaminants.

The written testimony will tell you that foreign manufacturers enjoy a significant advantage in the U.S. marketplace because they are not required to meet the same standards that we do, nor incur the investment that goes along with such conformance. The net effect of this is that we are systematically shutting down refining capacity in the United States and exporting the jobs overseas. This makes absolutely no sense, regardless of whether you are a business executive like myself concerned about the future of your company, a union leader concerned with job security or an environmentalist who realizes that closing the plant domestically only transfers the pollution overseas which still fouls the world's ecosystems.

Incidentally, I might mention that we have the full support of the president of our major union, the Oil, Chemical & Atomic Workers International Union, in this proposal today.

I will also tell you that shutting down our refining industry increases our dependence on a few foreign product manufacturers, and that creates a national security issue of the first magnitude.

Our written testimony on behalf of the Independent Refiners Coalition will clearly urge you, as I do now, to enact an environmental equalization fee on imported gasoline and blending components. In doing this, you will restore some sense of reason to the rule book and curtail the further erosion of an industry that has seen over 154 refineries shut down in the United States in the past 13 years.

I didn't come here today to complain about the billions our industry has to invest to comply with the Clean Air Act and other standards. This industry has heard the environmental message. We have made, are making, and will continue to make the necessary investments.

The company I work for, for example, is the first and only Fortune 500 firm to endorse the CERES environmental principles. In so doing, we have made a "no doubt about it" commitment to the environmental improvement and increased public accountability. I believe our environmental conscience and credentials are in order, and I know that the air, water, and soil quality in this country are improving, and that is something that we can all be proud of.

What we seek here today is to correct the consequences of a one-sided contest where we make a major investment in the environment while competing with foreign manufacturers who get a free ride in our markets. Their environmental laws are 5 to 20 years behind ours, and it gives them anywhere from a 5 to 10 cents per gallon advantage as a head start in the U.S. marketplace.

You should make no mistake about it: The U.S. refining industry is a world-class industry. We have made the necessary investments over the years to upgrade our plants and improve our productivity so that we are second to none in our business. However, the new environmental regulations have changed all of that. It just makes no sense to now squander our hard-won leadership position.

What we have won in the international competitive marketplace must not be lost by legislative inaction. Without an environmental equalization import fee on gasoline, additional refineries will close and additional jobs will be lost.

Why reward foreign manufacturers for their inattention to the environment while penalizing U.S. firms that are investing billions of dollars to improve air and water quality?

Gentlemen, by the decisiveness of your actions, steps and the speed with which you take them, you can send a message of fairness to the U.S. refiners and a message of reality to foreign manufacturers that the free lunch is over.

I thank you very much for your invitation to visit with you today.

[The prepared statement follows:]

Testimony Presented
On Behalf of the
Independent Refiners Coalition
September 8, 1993

Mr. Chairman and Members of the Committee, my name is Robert H. Campbell, President, CEO & Chairman of Sun Company, Inc. I am appearing today on behalf of the Independent Refiners Coalition of which my company is a member. The Independent Refiners Coalition is composed of twelve domestic independent refining companies who operate 27 refineries which have 15% of U.S. capacity. The members are Clark Oil & Refining Corporation, Louisiana Land & Exploration, The Coastal Corporation, Tosco Corporation, Crown Central Petroleum Corporation, Valero Energy Corporation, Ashland Oil Incorporated, United Refining Company, Tesoro, Kerr-McGee Corporation, Indian Refining, and Sun.

Independent refiners process more than 38% of the gasoline consumed in the United States and have been in business for more than 65 years. In 1992 there were more than 70 independent refining companies operating 140 refineries in 34 states employing 200,000 people. Independent refiners are defined as those who buy at least 70% of their crude oil requirements on the open market and rely largely on their refining and marketing operations to meet all of their capital requirements in contrast to integrated oil companies which have revenue streams from oil and gas production. In addition, they are primarily domestic in operations and not multinational.

One of the revenue raising proposals being considered in this hearing is to increase the tariff on imported crude oil and refined petroleum products. The Coalition has requested the opportunity to be heard today to testify in favor of a tax on imported gasoline and blending components. The Coalition's support for such a tax is joined by other refiners, as well. It is strongly felt by the Coalition and these refiners that a tax is needed on imported gasoline and blending stocks to offset the differential in the substantial embedded costs of environmental compliance in this country compared with relatively minimal environmental compliance costs faced by foreign competitors. This differential is an unfair trade advantage affecting our competitiveness and will cause a continued loss of U.S. refining capacity. The result is a threat to the national security of the United States, and the global environment.

This problem of a significant difference in protection of the environment between the United States and other countries creating an unfair trade advantage has been recognized by the Administration and members of Congress. For example, when the President was campaigning last year and announced his support for the North American Free Trade Agreement (NAFTA), he did so on the condition that the environment had to be protected on both sides of the border or it would lower Mexican cost of production which would be unfair to American workers.[1] Vice President Al Gore wrote in his book, Earth In The Balance, that "...weak and ineffectual enforcement of pollution control measures should also be included in the definition of unfair trading practices."[2] U.S. Trade Representative Mickey Kantor has testified on several occasions before the Congress on NAFTA pointing out that there would be a trade advantage in Mexico's favor if it failed to enforce environmental laws[3]. He also stated, "I think we'll recognize that if a difference is maintained, that will probably give a competitive advantage to a firm operating, say in Mexico, compared to that same firm operating in the United States."[4]

The Majority Leader of the U.S. House of Representatives, Congressman Richard Gephardt, has spoken of the need of other countries to have environmental laws and enforcement of them as a competitiveness issue[5]; as has Senator Max Baucus, Chairman of the Senate Environment and Public Works Committee.[6] In addition, Senator David Boren has introduced legislation in the past on the subject.[7] One scholar has written that even according to present law, the lack of environmental controls or the failure to enforce them should be considered a subsidy subject to a countervailing duty.[8] Therefore, representatives of the Executive and Legislative branches of our government have recognized that the lack of environmental protection laws and regulations or enforcement of them is a competitiveness problem for American industries. This has been recognized by environmentalists as well.[9]

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[1] Governor Bill Clinton speaking of the North American Free Trade Agreement at a presidential campaign rally at North Carolina State University, Raleigh, North Carolina, on October 4, 1992.

[2] Senator Al Gore, Earth In The Balance, (Houghton Mifflin Co.: Boston 1992) p. 343.

[3] Testimony of U.S. Trade Representative Mickey Kantor before the Senate Finance Committee, May 20, 1993.

[4] Testimony of U.S. Trade Representative Mickey Kantor before the Senate Environment and Public Works Committee on March 16, 1993.

[5] BNA Daily Report for Executives, May 12, 1993.

[6] Hearing of the Senate Environment and Public Works Committee, March 15, 1993.

[7] International Pollution Deterrence Act of 1991, S.984.

[8] Thomas K. Plofchan, Jr., "Recognizing and Countervailing Environmental Subsidies", The International Lawyer, Volume 26, Number 3 (Fall 1992), p. 763.

[9] Testimony of Robert F. Housman, Center for International Environmental Law, before the Subcommittee of Foreign Commerce and Tourism, Committee on Commerce, Science and Transportation, U.S. Senate, May 18, 1993.

The cost to domestic refining for pollution abatement is substantial and is higher than for most industries.[10] Based on older figures, it has been calculated that petroleum refining could account for a disproportionate 17% of the national environmental expenditure in the year 2000.[11] The domestic petroleum refining industry will, according to a very recent study done for the Secretary of Energy, invest $37 billion from 1991 through the year 2000 and $14 billion more from 2001 to 2010 to comply with government environmental regulations.[12] The sums spent this decade will actually exceed the total 1990 book value of all domestic refineries (after depreciation) which is only $31 billion.[13] Refineries spent 21% of their capital in the 1980's on pollution abatement, which will increase to 42% in the 1990's and 47% in the first decade of the next century.[14] The significance of this massive cost is that the cash flow of all of these refineries from 1991 through 1995 will be $25 billion less than the required environmental expenditures.[15] These new costs of environmental compliance will increase the cost of gasoline by approximately 5¢ a gallon in 1994 and will rise to approximately 13¢ a gallon by the year 2000,[16] on top of the historical pollution abatement costs for 1981 - 1991 of 2¢ a gallon.[17]

The recent National Petroleum Council (NPC) study is the only one of which we are aware that attempts to look at foreign refining environmental protection requirements. While we think this study in general has been very helpful, a great deal more work needs to be done in actually determining specific information on foreign environmental protection. There is, in our opinion, too much speculation as to what environmental standards will be applied when and where as well as whether or not they will be enforced. One review of the study has noted that unlike the detailed analysis of U.S. costs, the estimate of foreign costs "...is more arbitrary and assumption-based and thus subject to greater uncertainty."[18] The NPC study is aware of this shortcoming and has termed foreign cost estimates as subject to "significant uncertainty".[19] Foreign environment, safety and health costs present and projected need to be studied in much more detail and, due to the competitiveness problem, a study needs to be done as soon as possible.

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[10] Office of Technology Assessment, Congress of the United States, report "Trade and Environment", 1992. p. 98.

[11] American Petroleum Institute report, "Costs to the Petroleum Industry of Major New and Future Federal Government Environmental Requirements", October 1991, p. 21.

[12] National Petroleum Council, U.S. Petroleum Refining, August 2, 1993 Draft, p. 1. I-1.

[13] Ibid.

[14] Ibid., p. 1. I-2.

[15] Ibid., p. 1. I-1.

[16] Ibid., raw data used for conclusions in Chapter 1.

[17] Dept. of Commerce report MA-200.

[18] Wright Killen & Co. report, "A Broader Look at U.S. Refining Industry Survivability and International Competitiveness," June 8, 1993, p. 2.

Even with these caveats, the NPC study has concluded that, "...most foreign areas lag the United States in health, safety, and environmental regulations and, consequently, have lower embedded environmental costs than the United States."[20] For example, the U.S. presently spends 1.7% of its GDP on environmental programs while the European Community's average is only 1.2% or a third less.[21] The report goes on to note that although many countries have adopted some environmental regulations, it is "...far less common for these regulations to be enforced".[22] It is further observed that oil producing and lesser developed countries "...view government interests in refining as vital to national economic health - a belief that can supersede environmental agendas."[23]

The NPC report concludes that, "Overall, foreign regions today are estimated to be where the U.S. was roughly 5 - 20 years ago in terms of environmental regulations."[24] Thus, by the best information available, most competing refining areas of the world are any where from 5 - 20 years behind us and may or may not adopt similar environmental protection as required of our refiners. If they are adopted, they may not be enforced.

Even with the best case of a five year lag time for foreign refiners to "catch up" with U.S. environmental standards and enforcement, the damage to domestic refiners will have been done, and in all probability, will be irreversible. Over the critical next five years, imported gasoline will be readily available to replace reduced domestic production which will prevent U.S. market prices from rising to allow full cost recovery of increased environment, safety, and health costs.[25] Once a refinery closes for these reasons, it will not likely restart.[26]

The NPC report concludes that if foreign environmental protections do not materialize, the cost of foreign produced gasoline would be less than the United States.[27] This would result in increased imports of gasoline and reduced U.S. refinery utilization.[28]

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[19] NPC Draft report, Executive Summary, p. 37.

[20] Ibid., Executive Summary, p. 11.

[21] EOP Group, Inc., "The United States versus European Community", August 13, 1993, p. 3.

[22] Ibid., Appendix L, Section VII-9, p. 5.

[23] Ibid., p. 14.

[24] Ibid., Appendix L, Section VII-10, p. 1.

[25] Wright Killen & Co., June 8, 1993 report, p. 3.

[26] Ibid.

[27] NPC Draft report, Executive Summary, p. 11.

Today management teams at domestic refining headquarters around the U.S. face a most difficult quandary: Whether to commit the capital investments necessary for pollution abatement to continue operations knowing that lower cost imported product will make it unlikely to be profitable or not to invest. To no invest means to close the refinery.

A very important fact here that must be acknowledged is that although the NPC report concludes there is a similarity in the projected foreign refinery investments for the rest of this decade to American refining cost increases, those in the United States are largely attributed to the environmental requirements while foreign increases included a more significant capacity expansion.[29] Increased costs for environmental protection neither builds additional capacity to produce gasoline nor does it improve efficiency of existing capacity and while it is good for the ecology, it is nonproductive in terms of production of additional gasoline or producing it cheaper.[30] Rather, these costs add another layer of costs to products offered in competitive markets.[31] The report concludes that recovery of these costs are going to be difficult unless demand is increased by further refinery capacity shutdowns.[32]

Increasing refinery shutdowns is precisely what has been happening in the refining industry. In the 1980's, the number of domestic refineries dropped from a high of 315 to 184. 131 refineries closed for a 42% decrease in the number of refineries and the refining capacity fell from 18.62 million barrels per day to 15.7 or by 20%.[33] During that same time period, imports of foreign refined gasoline more than doubled from 140,000 barrels a day to 366,000.[34]

The shutdown of American refineries is continuing. Wright Killen & Co. conducted a plant-by-plant analysis of all refining operations in the U.S. in 1992. Their report predicted that 37 additional U.S. refineries with 1.5 million barrels a day of capacity or another 10% of the total capacity is at risk in closing in the next 3 - 5 years.[35] They have found that in the year since the 1992 study, almost a third of the predicted capacity closure, 498,000 barrels per day, has in fact closed.[36] At least one more refinery has closed since that June 8, 1993 update with a loss of another 50,000 barrels per day capacity.[37] That report is corroborated by the NPC study which predicts that there is going to be a substantial restructuring in the coming years characterized by shutdowns of refining capacity.[38] Indeed, the NPC study concluded that shutdowns accelerated in 1992 to the third highest level in history.[39] A third recent analysis reporting that dropping refining capacity "...is likely to continue due to the cost of complying with environmental regulations, particularly amendments to the Clean Air Act, and also due to narrow profit margins for most refining operations."[40] That USEA report predicts increased petroleum product imports as a result accompanied by dropping U.S. employment.[41]

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[28] Ibid.

[29] Ibid., Executive Summary, p. 39.

[30] Ibid., p. 1. II-2.

[31] Ibid.

[32] Ibid.

[33] Ibid., Executive Summary, p. 17; Office of Industrial Resource Administration, U.S. Department of Commerce, The Effect of Crude Oil and Refined Petroleum Product imports on the National Security, and Investigation conducted under Section 232 of the Trade Expansion Act of 1962, Table III - 3 (Dec. 1, 1988).

[34] Ibid., Table III-1.

Therefore, we have seen a 20% decline in refining capacity already and we are well on our way to a predicted additional 10% for a total of a 30% loss of domestic refining capacity in just over a decade. While additional imports will likely occur to offset the reduced domestic production, one should not focus on the amount of imports as the sole determinant of the problem. Refining and marketing price margins are just as important if not more so.

The way the gasoline marketing operates in the United States is that the marginal barrel of gasoline coming into a market sets the price. The price is set at the margin. Those last barrels of gasoline coming into the market are imported because we are not producing all that we consume. Because they have less embedded costs for environmental protection of at least 7¢ a gallon, they can sell their gasoline in our markets for less than that domestically produced even taking into consideration the difference in transportation costs of finished products and that of crude oil. Their marginal barrel coming in sets the price for all of the domestic gasoline. If domestic gasoline refiners don't lower their prices to meet imports, then more imported gasoline will come in further displacing domestic production which will then have no market since it costs more at the pump.

Today the margin of profit on a gallon of domestic produced gasoline is a penny a gallon or less. Thus, the 5¢

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[35] Wright Killen & Co. report, "Btu Energy Tax Study", May 1993, p. 2.

[36] Wright Killen & Co. study, June 8, 1993, p. 1.

[37] Marathon Oil Company refinery in Indianapolis, Indiana, The American Oil & Gas Reporter, August 1993, p. 14.

[38] NPC Draft report, p. 1. VI-1.

[39] Ibid.

[40] United States Energy Association, "U.S. Energy '93", May 1993, p. 3.

[41] Ibid.

a gallon differential now enjoyed by imported gasoline which will continue to increase is a significant factor depressing costs at the pump. If a domestic refiner cannot get back the capital it is going to have to invest in the future for environmental protection, it will not make that investment and will shut down the refinery. This is exactly the point made in the NPC study in comparing the total pollution costs of $37 billion over the rest of this decade substantially exceeding the cash flow of the refineries.

Unless there is some tremendous increase in demand for gasoline, which is not predicted by anyone, it is not possible for the rate of return to justify these expenses. Therefore, the real problem is not so much whether the present levels of imported gasoline are going to go up or down, but rather what is the marginal rate of return to the domestic refiner. As long as it is depressed as it currently is, more refineries will shut down rather than invest further. If the embedded cost differential disappeared, however, the margin would increase and refineries should remain on stream. The environmental playing field needs to be leveled.

There are several results to a continued shut down of domestic refineries. The first is the economic consequences to the United States. The additional 10% reduction in refining capacity, according to the conservative scenario of a recent economic analysis, would increase inflation .7 of a percent.[42] It would also affect interest rates by raising the short and long term rates by 40 basis points.[43] The report calculates that the dollar would rise as interest rates went up which in turn would inhibit the competitiveness of U.S. produced goods in international markets.[44] The decline in refining capacity would also affect U.S. employment by a decline of nearly 200,000 jobs.[45] Lastly, the Gross Domestic Product would see a decline of .3 of a percent in 1994 and 1995.[46]

A second result of this decline in domestic refining capacity is the effect on the national security of the United States. A recent report noted that five different Presidents - Eisenhower, Kennedy, Nixon, Ford and Carter - imposed restrictions on imports of refined petroleum products because they recognized that maintaining domestic refining capacity was essential to national security.[47] The report analyzes military needs in several scenarios and then compares those needs to our domestic refining capacity. There is a gap today between what we produce and consume of 1.8 million barrels a day which will grow in 1995 to 3.25 million barrels a day and by the year 2000 to 6.9 million barrels a day.[48] With a military conflict arising, the gap would obviously increase due to the needs of the military and military industrial complex, widening the gap to 4.9 million barrels a day in 1995 and a 8.6 in the year 2000.[49] "Even if draconian conservation and rationing measures were employed during a conflict and succeeded in achieving a reduction in civilian demand of as much as 20%, a severe shortage would still develop."[50] Therefore, the report concludes, "There can be no doubt in light of the enormous and growing gap between domestic refining capacity and domestic demand, that the tests set forth in the Ford Administration's standard for determining the point at which refined petroleum product import levels could constitute a national security threat has been met."[51]

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[42] The WEFA Group, "Macro Economic Impact of a Ten Percent Reduction in U.S. Refining Capacity," May 25, 1993, p. 3.

[43] Ibid., p. 5.

[44] Ibid., p. 7.

[45] Ibid., p. 8.

[46] Ibid.

[47] The National Defense Council Foundation, "Refineries in Crisis: The Threat to National Security," July 23, 1993, p. 3.

The economic impact and the threat to our national security are both to be avoided if at all possible. As has been concluded by the United States Energy Association, "The decline in our domestic ...refining capacity cannot conceivably be in our national interest."[52]

In our opinion, it is possible to avoid. Congress must take action to prevent further decline in our industry, damage to our economy, and a worsening of the threat to our national security. We propose that Congress pass a tax on imported gasoline approximately equalling the embedded costs differential of environmental costs starting at 7¢ per gallon on January 1, 1994 and increasing 1¢ per year thereafter until it reaches 13¢ per gallon on January 1, 2000. In our opinion, this tax will eliminate the differential environmental cost subsidy enjoyed by foreign refiners that will in turn cause an increase in the domestic refiners margins which will improve their profitability preventing further shut downs. This tax offers several advantages:

1. The tax would eliminate the unfair competitive advantage held by foreign refiners.

2. It would remove a further increase in the threat to national security of reduced refining capacity.

3. It would encourage domestic refiners to expend the money necessary for future environmental protection by giving them an opportunity to recover their costs.

4. It would eliminate the incentive for foreign refiners to resist imposition of environmental

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[48] _Ibid_., p. 9.

[49] _Ibid_.

[50] _Ibid_.

[51] _Ibid_.

[52] United States Energy Association, "Energy '93 Report", p. 10.

standards or their enforcement as they would no longer have a cost advantage.

5. It would provide additional needed revenues to the U.S. Treasury.[53]

Either Congress through legislation or the President under existing legislation could impose a tax on imported gasoline on the grounds of national security. Section 232 of the Trade Expansion Act of 1962 expressly authorizes the President to adjust imports by quotas or import fees which threaten to impair the national security.[54] This legislation is broad and does not define what constitutes a threat to national security as it is left to the President's judgment.[55] Six recent Presidents have already used this authority to regulate imports of petroleum and petroleum products. President Eisenhower used a quota[56], President Nixon imposed license fees[57], and President Ford increased the import fees[58].

The Congress can also legislatively find a threat to national security and impose a tax on imported gasoline. The fact that Congress granted to the President powers under § 232 of the Trade Expansion Act of 1962 was not an abdication of its constitutional responsibilities. Rather, it is a grant of concurrent power to the Executive Branch which gives the President the limited power to make national security findings under Congressionally prescribed circumstances, while Congress also retains its power to make a national security finding.[59]

A tax on imported gasoline passed by the Congress is also consistent with U.S. international obligations. It does not violate the General Agreement of Tariffs and Trade. Article XXI of GATT provides a specific exception to a contracting party imposing trade restrictions for reasons of national security. That Article reads in part: "Nothing in [GATT] shall be construed ...to prevent any contracting party from taking any action which it considers necessary for the protection of its essential security interests..." This Article makes no requirement about the manner in which a contracting party determines when it does have a national security interest sufficient to trigger this exception. GATT practice has been to defer to the decision of the contracting party when they invoke the national security exception.[60] It should also be noted that not all countries that export gasoline to the United States are contracting parties to GATT.

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[53] National Defense Council Foundation Report, p. 11.

[54] 19 U.S.C. § 1862 (c)(1)(A).

[55] Independent Gasoline Marketers Council v. Duncan, 492 F.Supp.614(D.C.D.C. 1980).

[56] Proclamation No. 3279, March 10, 1959, 24 Fed. Reg. 1,781.

[57] Proclamation No. 4210, April 18, 1973, 38 Fed. Reg. 9,645.

[58] Proclamation No. 4341, January 23, 1975, 40 Fed. Reg. 3,965.

[59] Consumers Union of U.S., Inc. v. Kissinger, 506 F.2d 136 (D.C.D.C. 1974).

Such a tax would also be an important environmental policy. If American businesses are expected to make significant investments to protect the environment, they must be reasonably secure in believing they are going to be able to get their money back from the operation of their business and not be rendered less competitive. This tax would show American refiners that our government is not going to let them lose competitiveness and that they have a chance in the marketplace to get their investment returned. By the same token, it will be a clear message to countries around the world that have not implemented environmental protections or are not enforcing them, that there will be no profit or trade advantage in their failing to do so. The domestic and international environment will be improved as a result.

A final result of this tax is that it will raise revenue. Even with exempting Canada with whom we have a free trade agreement, the tax beginning at 7¢ on January 1, 1994 and increasing 1¢ per year until it reaches 13¢ per year on January 1, 2000 will raise approximately $1.9 billion over the next five years.[61] Although it will raise a substantial sum of money, it will not reflect a corresponding increase at the pump. One report has estimated that the average U.S. gasoline pump prices would not increase by more than 1¢ per gallon and in some cases less than 1/4¢ per gallon as a result of the passage of this tax.[62]

Therefore, Mr. Chairman and members of the Committee the Coalition urgently requests that you pass a tax on imported gasoline and blending components in a miscellaneous revenues bill which might result from these hearings starting at 7¢ per gallon on January 1, 1994 and increasing by 1¢ per gallon a year until it reaches 13¢ per gallon on January 1, 2000 as necessary to protect the national security of the United States, help our domestic economy, protect the domestic and international environment, and give relief to the domestic refining industry from foreign unfair competition.

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[60] Handbook of GATT Disputes Settlement, Pierre Pescatore, Transitional Juris Publications, 1992, Part 1: Introduction, p. 58; GATT Activities 1986, pp. 58-59; GATT Activities 1987, pp. 69-70; John H. Jackson World Trade and the Law of the GATT(1969), p. 749; GATT Activities in 1982, p. 72; GATT Activities 1985, p. 47.

[61] Energy Information Administration, Petroleum Supply Monthly for Imports January - December, 1992 of Finished Motor Gasoline and Motor Gasoline Blending Components Totalled 121,668,000 barrels; divided by 42 gallons to the barrel equals 5,110,056,000 gallons multiplied times 7¢ and then an additional cent for each year through 11¢ in the fifth year equal $2,299,525,200 less imports from Canada that year which were 17% of the total; equal $1.9 billion.

[62] Wright Killen & Co., "The Effects of National Security Fee on U.S. Gasoline Prices", June 14, 1993, p. 1.

Mr. PAYNE. Thank you, Mr. Campbell.

Our next witness, representing the Independent Petroleum Association of America, Virginia Lazenby, chairman and chief executive officer of the Bretagne Corp., Nashville, Tenn.

Ms. Lazenby.

STATEMENT OF VIRGINIA LAZENBY, VICE CHAIR, CRUDE OIL POLICY COMMITTEE, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA, AND CHAIRMAN AND CHIEF EXECUTIVE OFFICER, BRETAGNE CORP.

Ms. LAZENBY. Good afternoon. I am here today on behalf of the Independent Petroleum Association of America, its 44 cooperating State and regional associations, and the National Stripper-Well Association where I serve as president. These organizations wholeheartedly support an oil import fee as part of a comprehensive plan to preserve domestic oil production.

Yesterday oil closed at $17.07 a barrel, down 66 cents, the lowest in 3 years. Most U.S. producers are receiving just $14 to $15 a barrel. Marginal production, 20 percent of our U.S. production, 2 million barrels a day, is operating at a significant loss—yes, loss, we are losing money.

We are being destroyed by cheap oil, which does not pay environmental costs. And our Government's response is to finance more cheap imported oil, which results in more destruction of the independent oil producers and their employees. On a personal note, just before I came over here today, I called Kentucky and I shut in a water flood a well that has been producing since the 1950s.

Mr. Chairman, there has been a rash of stories in the press lately about the U.S. Government's financial assistance to encourage oil production. Let me read from the September 3, New York Times entitled "Texaco Gets Aid to Invest in Russia."

The article explains, "The oil company has a project to restore production of 150 dormant wells in Western Siberia. The Overseas Private Investment Corp.—yes, a Federal agency—will provide $28 million of loan guarantees and insurance against political risk for the effort. The agency is prepared to provide up to $2.5 billion in new loans, loan guarantees, equity and insurance in the next year to support private investment in Russia."

I come here representing U.S. independent producers to ask your assistance to develop U.S. resources. It is not just the big multinational oil companies operating in Russia that need help from the U.S. Government. U.S. producers need capital, too, and rather than the $2.5 billion, 1-year program in Russia, we are asking for a $1.5 billion program spread over 5 years.

Keep in mind we may need this even more. Since we are told by the Government that the aim of producing Russian oil is to sell it on the world market, which will keep oil prices low and which, I might add, will put more U.S. independents out of business and increase the trade deficit by something like $7 billion and put 100,000 marginal producers out of business.

The experts say oil prices fell yesterday because demand is down in Russia. Just wait until the Russian production which our Government is subsidizing comes on line. How low will the price go then? When do we begin to think about American jobs?

An oil import fee is justified to create a price difference that better enables U.S. producers to compete, to offset their higher operating costs that result to a large degree from Government-mandated costs principally for environmental protection. You can bet that the U.S. subsidies for Russian oil development do not come with the same high-cost environmental requirements that U.S. producers must meet.

Three months ago I appeared before this subcommittee to discuss the increasing loss of marginal oil well production in the United States. I pointed out then that U.S. oil production had hit its lowest level since 1960.

Our trade deficit is dominated by oil imports; last year it was $45 billion. For the first time since June, the United States has consistently imported more oil than we produce. Thousands of barrels of marginal oil production have been shut in forever. U.S. companies have gone out of business.

According to Energy Secretary Hazel O'Leary, "This is not a political issue. Everyone agrees there is a problem. The question is how to solve it."

Even now, her department is finalizing a domestic energy initiative for the President. As part of that initiative, domestic oil and gas producers have advocated tax policy changes that will stimulate domestic oil and natural gas production. These are discussed in detail in our written statement.

Today I want to emphasize that these tax changes can be funded by a small increase in the current fee on imported oil and petroleum products.

Mr. Chairman, it costs more to produce oil here than anywhere else. A big part of these costs are for environmental protection and workplace safety. We pay for it, but U.S. oil production is safer and more environmentally sensitive than anywhere in the world.

In all the world, the U.S.'s 463,000 U.S. marginal wells are the most economically vulnerable, the most likely to be shut in if world oil prices stay at their currently depressed prices or fall even lower, a very real prospect.

If the United States adopts an energy policy that says simply "Back oil out of the market and substitute other fuels" like domestically produced natural gas, without some measure to preserve those marginal wells—it will be oil from U.S. stripper wells that will be backed out of the market, not imported oil. It will be producers in New York, Kansas, Michigan, Oklahoma and a dozen other States that will be forced out of business, not the sheiks and princes of OPEC countries.

A slight import fee to pay for a production credit with a floor price, which I understand the Clinton administration is considering as part of its domestic initiative, will give our country a much better energy policy, a policy that preserves domestic production and creates a level of price stability that will encourage investment.

Thank you, Chairman Payne. That concludes my testimony.

[The prepared statement and attachment follow:]

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

Statement by
Virginia Lazenby
on behalf of the
Independent Petroleum Association of America
before the
Committee on Ways and Means
Subcommittee on Select Revenue Measures

United States House of Representatives
September 8, 1993

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I am Virginia Lazenby. I am from Memphis, Tennessee and Chairman of Bretagne Corporation, an oil production company with marginal wells operating principally in Kentucky. I appear today on behalf of the Independent Petroleum Association of America, where I serve as the Vice Chair of the Crude Oil Policy Committee. I also am the president of the National Stripper Well Association.

I am pleased to provide views in support of an increase in fees on imported oil and refined petroleum products. I also want to address the need for changes in tax policy affecting domestic natural gas and oil production and to restate our concerns about other tax proposals that have been introduced in the House of Representatives.

BACKGROUND. It has gone unnoticed, but our nation had an anniversary this year. Twenty years ago this year, the Arab oil embargo brought America's energy vulnerability into stark focus for anyone who waited in a gasoline line. The 1973 embargo, and the oil price rise that followed it and the 1979 Iranian Revolution, spawned initiatives to improve U.S. energy security through various programs focused on conservation, production of synthetic fuels, fuel use mandates, and alternative fuels, but with little to stimulate domestic oil production. In fact, passage of the Windfall Profits Tax drained more than $78 billion dollars out of the domestic oil industry, when it should have been investing those resources into new domestic natural gas and oil reserves.

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What were the results of those everything-but-produce energy policy changes? Perhaps, that was best summed up by the Office of Technology Assessment (OTA) in October, 1991, which concluded that the United States was more vulnerable than ever to an oil import disruption.[1]

The OTA's conclusion was supported in principle by an earlier Department of Commerce investigation into the impact of oil import dependence on national security. On December 1, 1987 a coalition of associations, companies, and individuals petitioned[2] the Department of Commerce to investigate the impact of crude oil and petroleum imports on national security, asserting that imports had weakened the domestic petroleum industry to such an extent it that would not be able to support U.S. security needs in the event of war.

After an extensive investigation and public comment, the Department found that "petroleum imports threaten to impair the national security." The Department of Commerce noted that there had been substantial improvements in U.S. energy security since its 1979 investigation, but pointed out that *declining domestic oil production*, rising oil imports, and growing Free World dependence on potentially insecure sources of supply raised a number of concerns, including vulnerability to a major supply disruption. Regrettably, the report did not result in direct action by either the executive or legislative branches of the Federal government to decrease oil import vulnerability.

A substantial portion of Congressional energy policy action in the late 1980s and early 1990s was focused on repealing or greatly modifying the command and control provisions of various energy laws, even though the level of the nation's oil import dependence had begun to climb once again. It appears that the strength of political will needed to deal with our nation's dependence on imported oil had waned with the collapse oil prices in 1986. Outside of oil-producing states, cheap oil was not considered a problem. However, in the oil-producing states the results of cheap oil imports were devastating, with more than 465,000 jobs lost in less than a decade.

The Bush Administration launched its National Energy Strategy (NES) in 1989, which resulted in the Energy Policy Act of 1992. At the outset, the NES sought to decrease the nation's oil import vulnerability by opening previously restricted Federal lands to oil exploration and production, providing additional incentives for the use natural gas and alternative fuels, streamlining nuclear plant licensing, and encouraging greater conservation and energy efficiency. Not surprisingly, all elements of the proposed NES became law, except those proposals to open Federal lands for exploration and development; indeed, the Energy Policy Act of 1992 placed additional restrictions on offshore development and, as a result of a filibuster, was silent on the opening of a small portion of the Arctic National Wildlife Refuge to development.

The U.S. Congress added a tax title to Energy Policy Act of 1992, that substantially removed the "tax penalty" on domestic drilling and production imposed by the alternative minimum tax (AMT). While these AMT changes brought the effective tax rates of oil and natural gas producers closer to the level of those of other businesses, it did not provide new incentives for production and drilling. The last significant statutory tax incentive for domestic exploration and production, the Non-conventional Fuels Tax Credit, expired at the end of 1992. The "Section 29 credit" led to the development of extensive natural gas resources that probably would not have been developed at that time without the credit.

DOMESTIC ENERGY INITIATIVE.

In February of this year, Energy Secretary Hazel O'Leary announced a "Domestic Energy Initiative" that would seek to decrease the nation's oil import dependence, increase domestic oil and natural gas production, and reconcile energy and environmental goals. This month, the Department of Energy is expected to submit its energy policy recommendations to President Clinton. The IPAA and numerous other domestic energy groups have advocated an oil import fee as part of a comprehensive program to revitalize the domestic oil and natural gas industry.

OIL IMPORT FEE. The United States currently collects approximately $250,000,000 per year through fees on imported oil and refined petroleum products, as follows:

Item	Tariff Rate (per barrel)
Crude Oil	
less than 25 gravity	$0.0525
more than 25 gravity	$0.105
Gasoline	$0.525
Jet Fuel	$0.525
Residual Fuel Oil	$0.0525
No. 2 Fuel Oil	$0.105

IPAA SUPPORTS AN OIL IMPORT FEE. As the recent debate over the BTU tax demonstrated, any energy tax increase will be controversial and raises issues ranging from interfuel competition to disparate economic impacts among regions of the country, and consumer costs. However, unlike the BTU tax and most other alternatives, only an oil import fee gets to the core issue of this nation's energy policy -- the vulnerability created by the nation's excessive dependence on imported oil and petroleum. Only an oil import fee will help the domestic industry survive its nearly seven-year long depression and, in the process, create jobs.

EMPLOYMENT. As we have told this Committee on several occasions in the last two years, the U.S. oil and gas extraction industry has lost more than 450,000 jobs since its peak employment in 1982, more jobs than were lost in the automobile, textile, steel, and electronics industries. In the first quarter of this year, employment fell another seven percent from the same period last year. The domestic oil and natural gas industry has lost more jobs than it has retained over the last decade.

RIG COUNT. The rig count, the basic barometer of the industry's economic health, fell in June, 1992 to 596, the lowest level ever recorded and the sixth all-time low set in 1992, which had the lowest annual rig count ever.[3] Rig count for 1993, although improved since last year, is still at less than half the average level over the last twenty years.

TRADE DEFICIT. Consumption of natural gas and crude oil in the United States, by all official estimates, will continue to rise well into the future. If current trends continue, the U.S. could be importing 17 million barrels of petroleum each day by the year 2010. The climb in oil imports is readily evident. In 1991, crude oil and petroleum product imports accounted for more than 50% the nation's trade deficit. Low prices kept the value of oil imports below that level in 1992, but oil imports were 46 percent of the trade deficit and remain, as in years passed, the largest single component of the trade deficit. This year, as indicated earlier, more than 50 percent of the crude oil and petroleum products consumed in America is coming from foreign suppliers.

NATIONAL SECURITY. The IPAA was so concerned about this trend that we wrote President Clinton in January, and again in June, urging him to investigate the situation and to take action by imposing an oil import fee under the authority granted him under the Trade Expansion Act. We have not heard what the Clinton Administration plans to do on our request. We are willing to examine the upcoming Domestic Energy Initiative to see it makes substantial recommendations to improve domestic oil production. If not, the IPAA, other industry associations, and individual companies may file a petition under the Trade Expansion Act. We believe the issue of oil import dependence must be addressed directly.

Domestic natural gas and oil reserves are a national security and economic resource. Every barrel of oil and every cubic foot of natural gas produced in the United States creates wealth, jobs, and tax revenues at every level of government. Unfortunately, our nation is rapidly losing much of its ability to domestically produce the country's primary sources of energy -- oil and natural gas, which account for nearly 65 percent of the total energy consumption in the United States.

THE NEED FOR TAX POLICY CHANGES. Earlier this year, the IPAA testified before this subcommittee on H.R. 1024, the Energy Independence, Infrastructure, and

Investment Act of 1993, that proposes tax policy changes to maintain and enhance existing domestic natural gas and oil production, especially from economically marginal wells, and to encourage investment in new drilling. Without these or similar changes in tax policy, our nation will grow ever more dependent on imported crude oil as more domestic wells are plugged and abandoned, their resources effectively lost forever.

The United States has a rich endowment of potential domestic natural gas and oil resources that, with favorable exploration and development policies, can significantly reduce future oil imports. However, these resources will not be discovered and produced so long as our country does not aggressively counter the efforts of other governments to capture the capital investment needed to develop energy resources. The United States cannot sit idly by while every other nation with energy resource potential provides inducements to oil and natural gas investments.

Our government does seem to understand the need for economic inducements for natural gas and oil development. The United States is providing more than $2.5 billion in loans, loan guarantees, and other economic inducements this year for oil development in Russia, through the Overseas Private Investment Corporation, a federal agency. Independent producers, who account for about 60 percent of domestic natural gas production and about 40 percent of domestic crude oil production, are eager for economic conditions which would allow us to increase domestic natural gas and oil production. We also urge Congress to create incentives for maintaining and expanding production from the nation's marginal wells.

MARGINAL WELLS. The United States operated slightly more than 875,000 oil and natural gas wells in 1992, according to *World Oil*. About two-thirds of those wells are oil wells, or about 595,000 wells. Nearly 78 percent of the nation's oil wells are stripper wells, with an average per well output of about 2.2 barrels per day.

Marginal wells -- defined in the tax code as those wells that daily produce less than 15 barrels of oil and 90 thousand cubic feet of gas -- are essential to our domestic energy supply. They provide approximately 20 percent of domestic oil production in the lower 48 states. These high-cost marginal wells collectively produce more oil than we import from Saudi Arabia. Many stripper wells are already uneconomic to operate. Producers continue to operate these wells in hopes of higher future prices, but too often are economically forced to abandon the producing property before the mineral deposit has been exhausted. Stripper wells, which represent over 15% of domestic proven reserves, have been abandoned at rate of over 17,000 wells per year for each of the past 10 years. Once these wells are abandoned, their production and proved reserves are permanently lost, and our foreign energy dependency grows.

Let me point out, as the attached map clearly shows, that the greatest beneficiaries of changes in tax policy affecting marginal wells are states not traditionally viewed as "oil producing states."

DOMESTIC DRILLING. Just as we must preserve the productive capacity of existing wells, the nation must also encourage investment in drilling for new wells. Last year, drilling for domestic natural gas and crude oil hit the lowest level since records were kept beginning in the 1940s, and 1993 looks only slightly better.

H.R. 1024 is intended to spur new drilling, as well as improving the economic life of existing production. The IPAA supports the goals of this proposal; at the same time we have continued to explore alternative approaches to achieve the goals of H.R. 1024. The IPAA Management Committee recently approved a production-based credit proposal for existing marginal wells and new drilling, based on the approach used under the Non-conventional Fuels Tax Credit, as follows:

ELEMENTS OF THE PROPOSAL

I. NEWLY DRILLED WELLS would be eligible for a tax credit, based on production, as follows:

a) Newly drilled natural gas wells would receive a $0.50 per Mcf tax credit for the first 90 Mcf per day. Natural gas production in excess of 90 Mcf per day will receive a tax credit equal to $0.10 for each Mcf of such additional production per day.

b) Oil wells drilled in producing properties which produce an annual per well average of 25 barrels of oil per day or less would receive a production tax credit of $1.55 for each of the first 3 barrels of oil produced per well per day. The annual average production would be determined after considering the production from the newly drilled well.

c) Oil wells drilled in nonproducing properties which produce an annual per well average of 25 barrels of oil per day or less, would receive a production tax credit of $1.55 for each of the first 15 barrels of oil produced per well per day.

II. EXISTING STRIPPER WELLS. Existing oil and/or natural gas wells which on the date of enactment or subsequently qualify as a Stripper Well property would receive a production tax credit in the following amounts:

a) Oil: $1.55 for each barrel of daily production up to 3 barrels per day.
b) Natural Gas: $0.268 per mcf of daily production up to 18 mcf per day

III. OTHER CHARACTERISTICS

- Effective for production after June 1, 1994. The rate of the tax credit would be phased-in by one-third each year between 1994 and 1996, and indexed for inflation thereafter.

- Available to carry back 3 years (but not to a year which precedes the enactment date) and carry forward 15 years.

- Creditable against regular tax and alternative minimum tax, but not refundable.

- Available to working interest owners only. The credit would not be allowable for interests held by nonworking interest royalty owners, or royalty interests held by nonprofit organizations such as governments, universities or Indian tribes, etc.

- Workovers/recompletions earn the new well credit on incremental production.

- Only wells operating at their most efficient flow rate would qualify for the tax credit. Otherwise qualifying stripper wells operating at reduced production rates in accordance with state regulation will not be disqualified.

- Stripper wells which have increased their efficient production through workover expenditures to levels in excess of the stripper well rate will be allowed to retain eligibility for the tax credit for production up to the stripper well limits. (Qualification would continue under provisions similar to the newly drilled well limitations.)

- Existing Section 29 wells not be eligible for the marginal well production tax credit, until the existing Section 29 tax credit expires.

- Properties producing both oil and natural gas, a conversion ratio of 6 Mcf per barrel of oil would be used to calculate equivalent oil production, and eligibility would be determined by adding barrels of oil produced to the oil-equivalent of gas produced from each well.

NATURAL GAS DRILLING. The tax proposal outlined above will attract new capital and new drilling activity to all geographic regions of the domestic industry. It is needed. For the first time in several years, the industry needs to increase natural gas drilling levels to meet demand. Government agencies and private analysts have estimated that 500-600 rigs need to be drilling for natural gas to meet projected consumption. Only 298 gas rigs were drilling the week of May 7, 1993.

Equally important, the production-based credit will give a signal to domestic producers that their industry's contributions are viewed as necessary to achieve the administration's energy independence and economic recovery goals. It will also signal that the health of the domestic oil and gas industry is important to this administration and that the industry is not being singled out for the economic penalties which are inherent in all energy taxes.

REVENUE OFFSET. The revenue offset proposed by H.R. 1024 to pay for production and drilling tax changes could be used for the proposal outlined above. H.R. 1024 proposes an increase in fees on imported oil and petroleum products. While this is a preferred revenue offset from IPAA's perspective, the proposal for increased in fees on imported gasoline, advocated by domestic independent refiners, is also acceptable to IPAA if used to provide tax policy changes for domestic production and drilling.

ADMINISTRATION'S POSITION. At the June hearing on H.R. 1024, the Clinton Administration opposed making the proposed changes in energy tax policy as outlined in the legislation. The IPAA subsequently met with Assistant Secretary of the Treasury Leslie Samuels and others in the Department of the Treasury to discuss our proposals. We have urged the Clinton Administration to recommend tax policy changes as part of its Domestic Energy Initiative. We understand that the Administration is considering several tax policy options, including an oil import fee and a floor price on imported oil.

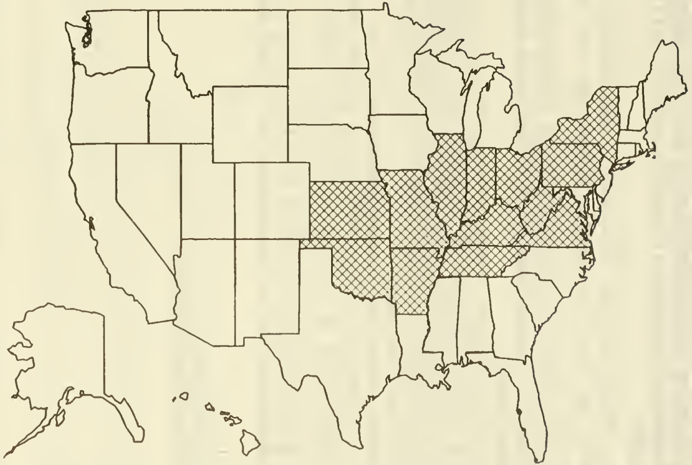
H.R. 2026, Sections 305 and 306. Finally, Mr. Chairman, I would like to restate the views of the Independent Petroleum Association of America in opposition to two provisions of H.R. 2026, Renewable and Energy Efficiency Incentives Act of 1993 -- Section 305 and Section 306. These two sections have virtually no impact on multinational oil companies; their detrimental impact, which is severe, falls squarely on the independent section of the domestic oil and natural gas industry and most particularly on marginal well producers. Section 305 would eliminate the long-standing and eminently logical distinction in tax law between depreciating assets (buildings, vehicles, machine tools, etc.) and depleting assets (oil and natural gas reserves, minerals, etc.) and would undermine an important element of the capital structure which, quite frankly, barely sustains the domestic independent oil and natural gas industry today. Section 306 repeals the exception from passive loss limitation for working interests in oil and natural gas properties. This provision would virtually eliminate a primary source of investment capital for domestic oil and natural gas exploration and development -- other oil and natural gas producers! Eliminating working interest investment capital, as proposed in Section 306, would reduce substantially the already anemic capital investment in drilling.

1. U.S. Congress, Office of Technology Assessment, *U.S. Oil Import Vulnerability: The Technical Replacement Capability*. OTA-E-605 (Washington, DC: U.S. Government Printing Office, October, 1991).

2. Petition was filed under Section 232 of the Trade Expansion Act of 1962, as amended, (19 U.S.C. 1862).

3. The 1992 annual rig count was 721.

STATES WITH 50% OR MORE STRIPPER WELL PRODUCTION



% of Total Crude Oil Output produced by Stripper Wells

Arkansas	52%	Kentucky	83%	Ohio	73%	Tennessee	81%
Illinois	93%	Missouri	86%	Oklahoma	75%	Virginia	100%
Indiana	100%	New York	88%	Pennsylvania	100%	W. Virginia	99%
Kansas	71%						

Source: National Stripper Well Association

Mr. PAYNE. Our next witness, representing the Petrochemical Energy Group and the Coalition on Energy Taxes, is David Damron, manager of government affairs, Hoechst Celanese Chemical Corp., Dallas, Tex.

STATEMENT OF R. DAVID DAMRON, MANAGER, GOVERNMENT AFFAIRS, HOECHST CELANESE CORP., INC., ON BEHALF OF THE PETROCHEMICAL ENERGY GROUP AND COALITION ON ENERGY TAXES

Mr. DAMRON. Thank you, Mr. Chairman. I will limit my verbal comments today to three concluding statements and one recommendation.

First, an oil import tax is a poor way to raise revenues. The ultimate cost in jobs, in competitiveness, in Government outlays, far exceeds the other benefits.

Second, the failures of past efforts to use a tax on imported oil, that is ranging from regulation of domestic oil, windfall profit taxes, and a bureaucracy allocating competitive advantages and trying to achieve regional equity in prices of oil, should not be visited again on the American people.

Third, an oil import tax will not address the problem of access to new sources of domestic oil and will induce problems with foreign sources, particularly if there is selective and discriminatory application.

The recommendation that we have is that the solution is to refrain from imposing any tax on imported oil or refined petroleum products.

Thank you.

Mr. PAYNE. Thank you.

[The prepared statement follows:]

BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

TESTIMONY IN OPPOSITION TO AN OIL IMPORT TAX
ON BEHALF OF
THE PETROCHEMICAL ENERGY GROUP AND
THE COALITION ON ENERGY TAXES

September 8, 1993

Thank you Mr. Chairman. My name is R. David Damron and I appear today on behalf of the Petrochemical Energy Group ("PEG") and the Coalition on Energy Taxes ("COET") at the hearing of September 8, 1993, as announced by Press Release #9. We appreciate the opportunity to be heard.

The companies represented are independent chemical companies.[1] That is, we are not vertically integrated with major oil companies. We are industrial consumers. We are not major producers, refiners, transporters, or marketers of oil or refined petroleum products. But we are major manufacturers who must consume oil and its derivatives in order to make goods for sale in the domestic and foreign markets.

Petrochemical manufacturers have the additional distinction of requiring oil and its derivatives, not only for fuel, but also for raw materials.

A. SUMMARY STATEMENT: THERE SHOULD BE NO FURTHER TAX IMPOSED ON OIL OR REFINED PETROLEUM PRODUCTS

One of the proposals under consideration at this hearing is:

> "Natural Resources"
>
> "2. A proposal to increase the tariff on imported crude oil by 15-cents-per-barrel and refined petroleum products by 1-cent-per-gallon."

We respectfully urge that there be no new tax imposed on imported crude oil or on imported refined petroleum products. A tariff or tax on imported oil and product can be expected to:

(1) decrease domestic jobs and productivity, thus lowering tax revenues and increasing social costs;

(2) decrease competitiveness of American-based companies in both the domestic and export markets, thus lowering tax revenues and further eroding the balance of trade;

(3) increase costs to all consumers of oil, just as the BTU tax on oil would have done, had the Congress decided to enact one in connection with the Budget Reconciliation Act;

(4) result in the revival of an elaborate bureaucracy to administer the program and to grant exemptions, subsidies, and entitlements to both domestic and foreign oil, and to resolve claims for redistribution of taxes and costs among States and Regions of the country;

(5) result in a revival of the Windfall Profit Tax on domestic oil;

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[1] Air Products & Chemicals, Inc., Dow Chemical Company, Eastman Chemical Company, Goodyear Tire & Rubber Company, Hoechst Celanese Corporation, PPG Industries, Quantum Chemical Corporation, and Union Carbide Corporation.

(6) be ineffective in encouraging exploration and production of new domestic oil reserves;

(7) be ineffective in stemming imports; and

(8) be inconsistent with respect to taxing imports, the inconsistency being based upon country of origin.

The reasons for these expectations are set forth below under three groupings:

B. The Effect on Jobs and Competitiveness is Too Negative to Justify an Oil Import Tax as a Deficit Reduction Measure.

C. An Oil Import Tax Has Been Tried In The Past and Was a Disaster.

D. A Tax or Tariff on Foreign Oil Will Not Serve To Displace Imports.

In connection with our testimony, we do not intend to discuss the levels of the proposed taxes or the differential between the tax on crude oil and refined petroleum products. We believe that, to do so, would detract from the point: no additional tax, at any level, should be enacted. Whatever the rate in the initial legislation, the amount could be changed upward at any time. Therefore, the amount only affects the degree of harm.

B. THE EFFECT ON JOBS AND COMPETITIVENESS IS TOO NEGATIVE TO JUSTIFY AN OIL IMPORT TAX AS A DEFICIT REDUCTION MEASURE (ITEMS A(1) TO A(3)).

Such a tax operates to drive the price of both foreign and domestic oil above the world oil price. This directly affects the ability of domestic enterprises to compete with foreign sources, thereby reducing domestic jobs and the ability of domestic companies to compete in both the American marketplace and the world marketplace.

There is already a serious problem facing this country with respect to the balance of trade. The Washington Post of June 16, 1993, reported that the United States is running an even larger deficit in the trade of goods. "Foreign demand for U.S. products continued to erode, totalling $112 billion in the first quarter, down from $114 billion the previous quarter. But U.S. imports of goods increased a fraction, to $140 billion." A headline in the August 20, 1993, issue of The Washington Post reads "U.S. Trade Deficit Hit Six-Year High in June; White House Voices Fear Over Yen's Strength".

A basic policy question to ask is whether it is prudent to affect adversely the ability of American industry to produce goods and to provide jobs in the country by adding still another tax in the form of an oil import fee?

I appear today as a representative of one segment of American industry, a segment that can be called "chemical" companies. Chemicals have been more exported than imported into this country. This has been a bright spot in the balance of trade, contributing a positive $16.3 billion in 1992 and providing employment for some 1.1 million employees. (Bureau of Labor Statistics, U.S. Department of Labor, "Employment and Earnings" (June 1993).)

Unfortunately, the trend is not good, due to global competition. In 1991, the positive balance of trade was $18.8 billion. (U.S. Bureau of Census, U.S. Department of Commerce, "U.S. Merchandise Trade, Jan 1991- Dec 1992 Final Report".) We need no further handicaps to our competitiveness.

Just to nail down the point, the Department of Commerce has noted that "small price differentials of its commodity products can determine whether it is better to produce or import primary petrochemicals." (International Trade Administration, U.S. Department of Commerce, U.S. Industrial Outlook 1993, "Chemicals and Allied Products" at 11-3 (1993).)

The Congress recently decided to raise revenues through a motor fuels tax and not through a BTU tax. (Omnibus Budget Reconciliation Act, Pub.L. No. 103-66.) An oil import tax has the same basic effect as a BTU tax on oil -- it raises the cost of petroleum-based energy and feedstocks to residential, commercial, electric utility, transportation, and industrial consumers. Hopefully, the issue will not be revisited.

Since we must withstand the allegations, obviously true, of being personally interested in the outcome, we respectfully suggest that we share views with a wide variety of expert Government agencies, and we would like to suggest review of several studies.

It is appropriate to review what the Congressional Budget Office ("CBO") found in its April, 1986 Study entitled "The Budgetary and Economic Effects of Oil Taxes." Two particular passages are relevant to this discussion. First, there is recognition that the tariff receipts as well as the higher taxes collected from domestic oil producers as a result of higher prices "would be offset by reduced corporate profits and personal incomes elsewhere, as higher energy prices raised business costs and reduced the income available for consumption of other goods and services." (Congressional Budget Office, "The Budgetary and Economic Effects of Oil Taxes", at 17 (1986).[2])

Second, the CBO in the same study, devoted a section to the "Effects on U.S. Trade and Competitiveness" at 39-42, a section recommended for study. Included at 39 is this statement:

> Whatever the net effects of oil taxes on the balance of trade and exchange rates, U.S. comparative advantage in international trade would be likely to shift away from those industries that are relatively oil intensive or energy intensive, since their foreign competitors would not be paying an added tariff on their energy or oil inputs [footnote omitted]. This would force U.S. firms to reduce their output or else accept smaller margins.

The CBO identified industries which it found to be vulnerable. These included paper, particularly in New England and the Middle Atlantic States, the chemical industry ("[t]he U.S. chemical industry also has substantial exports that could be placed at risk if their prices rose substantially", id. at 41), and agricultural exports.

The CBO is not alone in reaching these conclusions. The "National Energy Strategy: Powerful Ideas for America", noted that measures such as an oil import fee would have an adverse affect. ("National Energy Strategy: Powerful Ideas for America" at 5 (February 1991).) "But the cost would be very high -- in higher prices to American consumers, lost jobs, and less competitive U.S. industries." Id. (Accord U.S. Department of Energy, "Energy Security: A Report to the President of the United States" (March 1987).)

The Bureau of Economics Staff Report to the Federal Trade Commission, puts it this way: "The costs of using a tariff on oil imports to raise revenue appear to be quite high. At a minimum, the figures suggest that serious consideration should be given to finding a less-costly alternative before such a policy is adopted." (Keith B. Anderson

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[2] For the sake of completeness, the CBO tables indicate a conclusion that the tariff plus the corporate income and windfall profit taxes collected from domestic oil consumers as a result of the tariff would be greater than the loss of revenue in the consuming sector and residential sector, a conclusion noted to be inconsistent with that of DRI in the Congressional Research Service's report entitled "Oil Import Tax: Some General Economic Effects", CRS Report for Congress No. 87-259 E (1987).

& Michael R. Metzger, Bureau of Economics, Federal Trade Commission, "A Critical Evaluation of Petroleum Import Tariffs: Analytical and Historical Perspectives", at 52 (April 1987).) In sum, the cost to consumers and the cost to the economy are found to be greater than the tariff revenue raised.

Please also consider the March 1987 report of the Congressional Research Service of the Library of Congress entitled "Oil Import Tax: Some General Economic Effects" at 3 stating:

> An oil import tax would reduce the Federal Government budget deficit by less than a naive calculation would indicate. Lower economic activity would cut Government tax revenues; and higher prices would increase transfer payments with cost-of-living adjustments and Government outlays for supplies. Higher prices would also raise Government receipts -- by more than the outlays are boosted, but not enough to offset the effect of lower GNP.

Further, "[a]n oil import tax initially would tend to worsen the competitive position of certain U.S. industries. Energy costs of domestic energy-intensive industries -- such as petrochemicals, paper, and primary metals -- would tend to increase, while relatively lower oil prices abroad would lower production costs of competing foreign industries." Id. at 7.

Even avid proponents of an oil import fee concede the impact on competitiveness. The Energy and Environmental Policy Center at Harvard University, acknowledges that an oil import fee will destroy the ability of domestic petrochemical companies to compete in both domestic and world markets. (William W. Hogan & Bijan Mossanar-Rahmani, Harvard International Energy Studies, "Energy Security Revisited", (published by the Energy & Environments Policy Center, Harvard University (1987).) The suggestion is either that we simply go out of business in favor of foreign sources or that we seek government subsidies in order to remain in business. Neither is an attractive option to us. We hope that neither driving energy intensive manufacturers out of business nor subsidizing them is an attractive option to the Congress either, particularly for those industries who now manage to compete successfully in world markets and earn a favorable balance of trade for this nation.

Therefore, we respectfully suggest that the costs of an oil import tax are too high, and the tax on imported oil and refined petroleum products should not be adopted.

C. AN OIL IMPORT TAX HAS BEEN TRIED IN THE PAST AND WAS A DISASTER (ITEMS A(4) AND (5)).

The concept has been tried in the past and abandoned. Oil import quotas, fees, tariffs or taxes did not work. The disruptions to the economy were both real and intense. The program, in any form, should not be revived. Once should be enough.

The oil import quota, fee, or tax was imposed in this country in one form or another from 1958 until 1981. (Exec. Order No. 12,287, 3 C.F.R. 124 (1981), *reprinted in* 46 Fed. Reg. 9909. (1981).) Now, even twelve years later, the complexities and the litigation arising out of that entire scheme have still not been resolved. (Final Filing Deadline in Special Refund Proceeding Involving Crude Oil Overcharge Refunds, 58 Fed. Reg. 26,318-26,319 (1993).)

In brief summary, from 1958 until the early 1970's, a "quota" system was imposed on grounds of national security. This was called the "Mandatory Oil Import Program", or MOIP. At the time, the U.S. had the ability to supply all the oil that this country needed as well as to meet the needs of foreign countries in times of crisis. The basic thought was that foreign oil, being cheaper following World War II, would displace too much domestic production and, thus, had to be limited.

The program started out as a system whereby imports of foreign oil and foreign refined products were "licensed" for import, sometimes called "tickets". Since, at the time, foreign oil was perceived to be "cheaper" than domestic oil, the ability to import provided a profit opportunity represented by the difference between the price of a domestic barrel and the price of a foreign barrel. Companies who had "tickets" allocated to them by the Federal Government thus gained a competitive advantage over those who did not get an allocation of "tickets" from the Federal Government.

Needless to say, before a decade was over, legislative and administrative battles were fought for exemptions from the quotas for certain regions and the "tickets" were distributed to refiners and petrochemical companies in ways that the Government thought achieved economic equity. (See Cabinet Task Force on Oil Import Control, "The Oil Import Question: A Report on the Relationship of Oil Imports to the National Security", (February 1970).)

The Petrochemical Energy Group came into existence in 1972 for the purpose of seeking equity between independent petrochemical companies and the petrochemical arms of major refiners, who were allocated "tickets."

The second phase started in the early 1970s, not uncoincidentally about the time that the Texas Railroad Commission and the other producing states went to 100% allowables, or the equivalent thereof, for their programs for prorationing the production of oil. To OPEC or elements thereof, this was the signal that the U.S. had not only lost its ability to send oil to Europe in times of crisis, such as the brief war over the Suez Canal, but that the U.S was no longer self sufficient. It may be better to express this point in the exact words of the Congress of the United States in the Emergency Petroleum Allocation Act of 1973:

> Sec.2(a) The Congress hereby determines that --
>
> (1) shortages of crude oil, residual fuel oil, and refined petroleum products caused by inadequate domestic production, environmental constraints, and the unavailability of imports sufficient to satisfy domestic demand, now exist or are imminent.

The rest, as they say, is history. The quota system did not maintain and protect domestic production capability so that the U.S. could be self-sufficient in oil. Imports became a practical necessity over twenty years ago.

At least two major embargoes of exports to the United States took place in the 1970s, together with rapidly escalating oil prices, led by the prices from abroad. (See Daniel Yergin, The Prize: The Epic Quest for Oil, Money, and Power (1992).)

A quota, of course, became obsolete, and the "fee" (another word for tax or tariff) on imported oil was substituted. Not only did an oil import fee come into existence, but the regulatory bureaucracy needed to manage the MOIP had to be expanded in order to take over the allocation and pricing of domestic oil as well as to allocate subsidies and the like. A new feature was added: a Windfall Profit Tax on domestic oil. These two features will be discussed immediately below.

First, there was the enlargement of an even more elaborate regulatory scheme, far eclipsing that under the quota system. This included agencies for allocating and pricing both domestic and foreign oil and refined petroleum products. While the degree of regulation varied over the next decade, at its zenith the effort was made by the federal government to equalize the cost of all domestic oil and all imports as well as to provide subsidies to those enterprises thought deserving of subsidy. Rather than "tickets", these were called "entitlements." Entitlements were exchanged for cash. The Department of Energy's current Secretary -- the Honorable Hazel O'Leary -- was, in her prior Government service, in charge of this elaborate bureaucracy.[3] Such a bureaucracy lies dormant at the DOE, with ration books and allocation schedules ready to go, once the Government sets a differential between foreign and domestic oil and the scramble is on to evade the tax, to profit from the tax, or to minimize the competitive harm in the tax. See 10 C.F.R. § 211, App. A (1993).

Second, there was a Windfall Profit Tax. (Crude Oil Windfall Profit Tax Act of 1980, Pub.L. No. 96-223, 94 Stat. 229 (April 2, 1980)(repealed 1988).) In essence, this tax sought to divert to the Treasury some of the price increases for domestic oil and product which were made possible by the higher foreign prices plus the oil import tax, acting as a tariff barrier. (The Btu tax, included in the House-passed version of the Omnibus Budget Reconciliation Bill of 1993, had the same basic effect as a Windfall Profit Tax in that it was applicable both to domestic and to foreign oil.)

In net effect, the two phases were remarkably similar, as stated in a Report of the Department of Energy entitled "The Effect of Legislative and Regulatory Actions on Competition in Petroleum Markets." The following statement sums it up:

> Domestic oil prices, now regulated by formal price controls, were previously regulated (in effect) through state prorationing laws and oil import quotas. The cost equalizations among refiners made possible by the Entitlements Program exhibited similar tendencies under the quota tickets of the Mandatory Oil Import Program. The same groups which received special benefits under pre-Embargo regulations now receive those benefits under new regulations; small refiners, importers of residual fuel oil into the East Coast, and PADD V refiners all receive special consideration under the Entitlements Program similar to that received under the MOIP. The only change in the focus of the regulations appears to be the direction of price controls. Whereas before the Embargo, domestic oil prices were supported at a higher level than would have been obtained by market forces, the current regulations maintain them at a lower level than the "free" market price.

("The Effect of Legislative and Regulatory Actions", supra note 3, at 59.)

The last sentence in the above quote sums up the basic question: is the effect, if not purpose, of the tax to drive domestic prices up or to hold them down? If there is a differential in tax between foreign and domestic oil as a result of the tariff, who gets the benefit of the differential? Who administers it? Will all or some of the differential be taken in taxes on domestic oil or not -- e.g., the revival of the Windfall Profit Tax? Are there those who should be sheltered or subsidized by means of the taxes? Should those who live in States where the imports arrive pay all of the tariff or should some method be devised to spread the tariff to other regions? Or should the States, such as those on the Eastern Seaboard, be exempted from the import tax and the tax rerouted to other regions?

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[3] Some recommended sources for further study are Reserves and Natural Gas Division Office of Oil and Gas, U.S. Department of Energy, "A Chronology of Major Oil and Gas Regulations Issued Through October 1985", DOE/EIA-MO16 (1986); Energy Information Agency, U.S. Department of Energy, "The Impact of the Entitlements Program on the Market for Residual Fuel Oil on the East Coast" DOE/EIA 0184/29 (February 1980); Energy Information Agency, U.S. Department of Energy, "The Effect of Legislative and Regulatory Actions on Competition in Petroleum Markets", DOE/EIA-0201/2 (October 1979); Energy Information Agency, U.S. Department of Energy, "Effects of Oil Regulation on Prices and Quantities: A Qualitative Analysis", DOE/EIA-0201/1 (October 1979); Energy Information Agency, U.S. Department of Energy, "Effects of Oil Regulation on Prices and Quantities: A Qualitative Analysis", DOE/EIA-0184/3 (May 1979); Energy Information Agency, U.S. Department of Energy, "The Effect of Legislative and Regulatory Actions on Competition in Petroleum Markets", DOE/EIA-0187/7 (April 1979); Energy Information Agency, U.S. Department of Energy, "Proposed Amendments to the Entitlements Program with Respect to Imported Residual Fuel Oil", DOE/EIA-0102/30 (July 1978).

These are some of the issues that arise whenever an oil import fee, tax, or quota is considered. These and other issues are thoroughly explored in "A Critical Evaluation of Petroleum Import Tariffs: Analytical and Historical Perspectives", Bureau of Economics Staff Report to the Federal Trade Commission (April 1987). Particularly recommended for review is the Conclusion on page 31, wherein the inevitability of appealing to the political process for "special deals" is discussed, since "substantial economic benefits would accrue to parties who obtained exemptions from a tariff that allow them to import without restrictions. Such special deals could take the form of exemptions for certain products, for products imported from certain countries, or just for imports by certain firms." Furthermore, page 56 of the same report states:

> In the course of designing and implementing a tariff, various parties will seek, and likely obtain, special exemptions. Such exemptions, whether for certain products, firms, or countries exporting to the United States, would be particularly valuable to the favored groups. However, tariff revenues would probably be reduced as a result, and administrative costs would likely be increased. Moreover, many of these special exemptions would encourage inefficient U.S. production of refined petroleum products and of other products. As a result, the U.S. would become less competitive in world markets. All of the above points suggest that the social costs of a tariff would be greater than our estimates. Similar costs are likely if other policies are used to aid the oil industry.

The oil import fee, or tax, or tariff, or quota died a natural and welcome death over a decade ago. Please let it rest in peace.

If it is to be revived, please then provide for sufficient exemptions to maintain parity of the domestic manufacturing industry with foreign-based manufacturing industry and please maintain parity among the domestic manufacturers so that the Government does not give a competitive advantage to one segment over another.

Also, please set standards for the bureaucracy which will be needed to administer the program. Please assure that all who ask to be heard on the question of allocations and exemptions -- and their adversaries or competitors -- be given a fair and expeditious hearing. The federal agency which will be given responsibility for administering the program should be clearly identified from the start.

D. A TAX OR TARIFF ON FOREIGN OIL WILL NOT SERVE TO DISPLACE IMPORTS (ITEMS A(6) TO A(8)).

This country, years ago, elected to utilize a Strategic Petroleum Reserve ("SPR") as the primary means of dealing with supply disruptions. The SPR deals with the situation where foreign sources choose to cut off exports to the United States. The tax or tariff deals with the situation where imports are being discouraged and, presumably, domestic sources gain the protection of a tariff barrier and can raise prices on current and future production. The question is: what can reasonably be expected as a result?

For purposes of this section, we assume the following scenario: there will only be a tax on imported oil and imported refined petroleum products; that there will be no price controls imposed on domestic oil or product; that there will be no Windfall Profit Tax imposed on the domestic production; that the tax will act as a tariff barrier allowing all domestic prices to rise at least to the level of the tariff; and that all of this differential is retained by the producers and refiners of oil.

The first expectation that should be considered is that of regional fairness. It probably can be taken as a given that consuming States, particularly those along the Eastern Seaboard, would bear the brunt of an oil import tax. The expectation might be that producing states would be the beneficiaries of an oil import fee, but this expectation cannot be taken as a given. It has been tested.

If there is any State in the Union which could be expected to benefit from the scenario stated above, it is the State of Texas, a State near and dear to the hearts, as well as the location of plants of many petrochemical companies. However, "an oil import fee is not likely to have a significant impact on the state's economy." (Texas Economic Outlook, "How Would an Oil Import Fee Impact the Texas Economy", published by the Center for Business and Economic Analysis, Graduate School of Business, Texas A & M University, at 5 (February 1992).) That quotation was summarizing the conclusion of the study "Impacts of Oil Import Fees on the Texas Economy," conducted at the same institution, by Dr. M.A.M. Anari, Research Economist, and Dr. Jared E. Hazelton, Director.

If there will not be a significant impact on the economy of a producing State as key as Texas, where and how will there be an effect? The next expectation is that an oil import fee would be beneficial to the domestic oil industry and, therefore, to this country by fostering a significant increase in exploration and development of new oil reserves. The objective then, of an oil import tax, would be to foster a significant increase in exploration and development of new oil reserves.

PEG will yield to none in associating with the view that it is extremely important that there be a healthy and viable domestic oil and gas industry and that encouragement for exploration and development of new oil reserves is indeed important. Therefore, any possible "stimulus" for exploration and development should be carefully considered.

The question is, is a tariff on imported oil an effective answer to the need for exploration and development of new domestic oil and gas reserves?

We think not. The problem involving exploration and production of new oil reserves is not going to be solved or even addressed by a tariff on imported oil or any indirect subsidy to some or all domestic oil production and refining. What is needed is access to promising new sources of domestic supply for the purpose of exploration and production. The problem is caused by the fact that it is the national policy of this country to deny access to promising new sources of domestic supply.

Perhaps the best way to demonstrate this last point is to quote from the Report to Stockholders of the Chevron Corporation for the First Quarter of 1993. The headline on page five and the first two paragraphs are quoted:

> CHEVRON IS SHIFTING EXPLORATION AND PRODUCTION EFFORTS OVERSEAS.
>
> Chevron is shifting its exploration and production emphasis to areas with the strongest potential for large discoveries and cost-effective production, Vice Chairman Dennis Bonney told stockholders.
>
> "Most of the new opportunities lie outside the United States," he explained. This is partly because most of the world's "truly attractive untapped petroleum reserves are overseas." Also, "many U.S. Regions with high potential have been placed out of the industry's reach by government actions."

The Office of Technology Assessment ("OTA"), an arm of the Congress, in its October 1991 summary "U.S. Oil Import Vulnerability: The Technical Replacement Capability" at 17, indicates a similar conclusion:

> The scarcity of new opportunities for finding large new oil fields within the mature oil regions of the lower 48 States has created pressure for the Federal Government to open to exploratory drilling and development a number of promising areas currently off-limits to such activities, such as the Arctic National Wildlife Refuge (ANWR), offshore California, and other frontier areas.

The OTA notes on that same page that DOI has estimated that ANWR has a 46% chance of recovering 3.6 billion barrels -- "a potential resource equivalent to the third largest discovery in U.S. territory and one that, for a few decades, could deliver several hundred thousand barrels of crude oil per day to the lower 48 States." Id. (footnote omitted).

These statements by a major oil company and the OTA, we fear, reflect all too well the current situation. This nation cannot expect to maintain its ability to produce and to refine domestic oil even at current levels if access to the resource bases are denied by the Federal Government.

We recognize that this is an unpopular subject. We know full well that the National Energy Strategy called for "environmentally responsible development of promising areas like ANWR and OCS." (National Energy Strategy, supra, at 3.) We are aware that legislation to achieve that result died on the floor of the Senate and did not make it to the Energy Policy Act of 1992. (137 Cong. Rec. S15,754 (daily ed. Nov. 1, 1991)(Rollcall Vote No. 242, failure to invoke cloture on motion to proceed to consideration of S. 1220, National Energy Security Act of 1991).) To us, the conclusion to reach is that the Congress is not presently prepared to address issues related to access to the resource base for new domestic oil reserves. Whether that is good or bad public policy makes no difference here. It is the fact.

The inescapable corollary is that higher and higher percentages of oil imports must be accepted. Without a significant increase in access to potential reserves in this country for the purposes of exploration and production, imports are bound to increase in volume, and the question is not whether, but where, the imports come from. Taxing the imports only adds to the cost.

As Section B demonstrates, an oil import fee is a poor source of revenues. Section B assumes, arguendo, that an import tax will be collected on all foreign oil and all foreign refined petroleum products. This assumption is extremely unlikely to be achieved in practice, thereby both reducing anticipated tax revenues and increasing administrative costs to the Government and extraneous costs to the economy. The expectation would be that some countries' exports to the United States would be exempted from the tax.

Where the imports come from raises this thorny issue for those who would impose a tax on imports: would any foreign source be exempt? Canada, for example, under the Free Trade Agreement? What about the other countries who now provide oil to the United States? According to the EIA, some 32 countries other than Canada have exported to the United States continually or from time to time over the last twenty years. (Office of Energy Markets and End Use, U.S. Department of Energy, Monthly Energy Review, Tables 3.3(a-h), DOE/EIA-0035(93/07)(July 1993).) Would the Congress exempt any foreign source from an import tax? Or would that be a decision for the Administration to make?

The GAO, in its 1986 Report entitled "Petroleum Products, Effect of Imports on U.S. Oil Refineries and U.S. Energy Security", had this admonition:

> Possible side effects should also be considered in weighing the desirability of tariffs or quotas. One such side effect is the potential for retaliatory trade measures by other nations in response to U.S. tariffs or quotas. For example, product-exporting nations could establish restrictions on purchases of U.S. products, or reduce cooperation with the United States in other areas. In addition, other product-importing nations, principally members of the European Economic Community and Japan, may respond to U.S. trade restrictions with restrictions of their own. As we noted in chapter 3, Japanese government officials have indicated a possible relaxation of its ban on imports of gasoline and other products, and the Community presently does not enforce trade restrictions against Saudi Arabia, Kuwait, and other major product-exporting nations. Retaliatory measures by these countries to restore or augment trade barriers could undermine the effectiveness of the U.S. trade restrictions.

(General Accounting Office, "Petroleum Products, Effect of Imports on U.S. Oil Refineries and U.S. Energy Security", GAO/RCED-86-85 at 63 (April 1986).)

In sum, imposing an oil import tax is not going to do anything to increase access to the most promising potential new reserves of oil. If the State of Texas is a good representative of a producing state, an oil import tax will not do much regional good while harm to other regions is manifest. A host of international trade and other considerations come into play if the tax is imposed on some countries but not on others. To the extent that country of origin exemptions are given, tax revenues are reduced and the regulatory mechanism must police the imports to be sure that the "country of origin" is not simply a paper transfer on the high seas, with delivery by displacement.

E. CONCLUSION

We respectfully suggest that we have demonstrated that:

- An oil import tax is a poor way to raise revenues, the ultimate cost in jobs, in competitiveness, in other government outlays, far exceeding any benefit.

- The failures of the past efforts to use a tax on imported oil, ranging from regulation of domestic oil, Windfall Profit Taxes, and a bureaucracy allocating competitive advantages and trying to achieve regional equity in prices of oil, should not again be visited on the American people.

- An oil import tax will not address the problem of access to new sources of domestic oil and will induce problems with foreign sources, particularly if there is selective or discriminatory application.

The recommended solution is to refrain from imposing any tax on imported oil or refined petroleum products.

Mr. PAYNE. Our next witnesses will testify concerning the severance tax on hard rock minerals. Representing the Mineral Resources Alliance and the American Iron Ore Association are Steve Alfers, counsel, and John Kelly, tax counsel for the American Iron Ore Association.

Please proceed.

STATEMENT OF STEPHEN D. ALFERS, COUNSEL, MINERAL RESOURCES ALLIANCE

Mr. ALFERS. Thank you, Mr. Chairman. I am Steve Alfers, a partner in the law firm of Morrison & Foerster from Denver, Colo. I appreciate the opportunity to be here today on behalf of the Mineral Resources Alliance, an association of more than 1,000 mining companies, vendors and their supporters.

I have submitted to the committee a written statement and I would refer the committee to that statement. My comments here today will be brief.

We oppose the severance tax proposal. We think it has four very serious problems. First, the proposal does not define either a method of calculation or the basis of the severance tax. The proposal calls for a 12 percent tax on hard rock minerals, but does not specify what minerals are to be taxed, the basis upon which the tax would be calculated or whether the taxes be levied on minerals from public lands, private lands or both.

We can't tell whether the tax would be limited to metals or also include nonmetallic minerals, industrial minerals such as talc and some of the strategic minerals, the rare earths, or even ferrous metals. No data has been assembled to determine the revenue impacts of the tax. No detailed financial or economic analysis of the proposed tax exists from which an accurate projection of revenues could be determined. Revenue projections would be guess work.

Congress should not consider this new tax without first conducting a study to determine the revenue impact of the tax. It is impossible to predict the impact of the proposed severance tax without applying that tax to real numbers from real existing hard-rock mining projects. Short-term economic analysis is especially misleading in the mining industry.

Economic projections should be based on long-term economic analysis and the models should incorporate actual financial and production data from U.S. mining operations covering a variety of metallic and nonmetallic mineral deposits. Producing gold is not like producing lead or uranium or copper or zinc or beryllium or other industrial minerals or almost any other mineral, and it is a mistake to try to project economic impacts based on anecdotal information about a single metal or a single gold mine.

Finally, based on economic studies of the U.S. mining industry, it is likely that the net Federal impact would be negative.

A recent study by Coopers & Lybrand and Morrison & Foerster showed that a Federal royalty on hard rock minerals had a negative economic impact and high Federal royalties in the range of 8 to 12 percent had a negative impact on the Federal Treasury.

Severance tax on minerals in public lands would have a similar impact and a severance tax that would extend to minerals on public and private lands would have a greater impact. This could be translated to jobs. Some mines would close. Other mines would downsize and contract their operations, shorten their mine lines, throw off employees.

Perhaps the biggest economic impact would be from mine construction projects on the drawing board that would no longer go forward. These would just simply drop off. That would mean loss of jobs and tax revenues and loss of exports. We can calculate that. What we can't calculate is the fact that many mines would never be discovered, because the exploration dollars would migrate overseas at the bleak economics prospects here.

We continue to need the gold and silver and copper and lead and zinc and beryllium, platinum, chrome, uranium, and many other commodities, some of which we haven't even discovered yet. That loss is incalculable. Since 1989, Congress has been considering reform of the general mining law governing mining on public lands in the United States. A bill reforming the mining law has now passed the Senate and action is expected in the House this year, perhaps next month. Both bills substantially reform the mining laws.

New mining fees and royalty on production are part of both bills. These fees and royalties portend an enormous impact on mining. In anticipation of these bills, industry has already reduced its holding of mining claims in the United States by one half. Some sources expect a decline in holding of mining claims by up to 80 percent.

U.S. exploration dollars, a clear signal of whether production will come in the future, are already migrating overseas. This is not the time to entertain new taxes on the mining industry. A wiser course is to let mining law reform play out over these next few weeks. Then Congress can watch carefully over the next few years the economic impact of mining law reforms before considering new taxes on this beleaguered industry.

Thank you, Mr. Chairman.

[The prepared statement follows:]

HEARING ON MINERAL SEVERANCE TAX ISSUES
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

WRITTEN STATEMENT
OF
STEPHEN D. ALFERS
ON BEHALF OF
THE MINERAL RESOURCES ALLIANCE

SEPTEMBER 8, 1993

On August 17, 1993, the Honorable Charles B. Rangel announced hearings to be held before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee on September 8th and September 14th. I appreciate the opportunity to offer testimony on September 8, 1993 on the impact of a 12% severance tax on the mining industry. This written statement, which supplements my Preliminary Statement offered on September 8, contains my assessment of this proposed severance tax.

INTRODUCTION

Since 1989, Congress has been considering reform of the General Mining Law governing mining on public lands in the United States. A bill reforming the mining law has passed the Senate (S.775) and action is expected in the House this month or next.

Both bills substantially reform the mining laws. New mining fees and royalty on production are part of both bills. These fees and royalties portend an enormous impact on mining. In anticipation of these bills, industry has already been adversely affected. The U.S. mining industry has already reduced its holdings of mining claims by more than one-half -- some sources expect close to 60%-80% reductions -- and U.S. exploration expenditures, a clear signal of future production, are already migrating overseas.

This is not the time to entertain new taxes on the mining industry. The wise course is to let Mining Law reform play out over these next few weeks. The Congress should watch carefully the economic impact of Mining Law reform before considering new taxes on this beleaguered industry.

STATEMENT

There are four fundamental problems with the proposed severance tax: 1) The proposal does not define the method of calculation or the basis of the severance tax, 2) no verifiable data has been assembled to determine the revenue impacts of the tax, 3) Congress should not entertain such a proposal without conducting a study to determine the revenue impacts of the tax, and 4) based upon previous studies, it is likely that the net federal revenue impacts of such a tax would be negative. I will address each of these points below.

1. The Proposal Is Vague

The proposed severance tax calls for a 12% tax on "hard rock" minerals, "such as gold, silver and copper." The proposal, however, describes neither the minerals to be taxed, the basis upon which the tax will be calculated, nor whether the tax will be levied on minerals produced from both public and private lands.

Perhaps the proposal would impose a tax only on gold, silver and copper, or, perhaps, all metallic minerals (sweeping in lead, zinc, platinum, chromium, and beryllium, to name just a few). Or perhaps the proposal is to reach "locatable minerals."[1]

If the tax is to be applied to all minerals, it will have an enormous direct impact on nearly every state in the country. If the tax is to be levied only on "locatable" minerals or metallic minerals, the tax will have a disproportionately large direct impact on the western states where most of that mineral production occurs. But the tax would also have a tremendous indirect impact on those states -- chiefly in the midwest and the mid-Atlantic -- which supply the machinery and supplies used in metals mining.

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[1] The list of locatable minerals could include the following list of minerals: gold, silver, cinnabar, lead, tin, copper, building stone, salt springs and other deposits of salt, gilsonite, elaterite or other like substances, kaolin, kaolinite, fuller's earth, china clay and ball clay, phosphate, nitrate, potash, asphaltic minerals, sodium, borax, sulphur, agate, albertite, alkaline substances, alum, aluminum, cyanite, amber, amphibole schist, amygdaloid bands, asbestos, asphalt, barium, bauxite, bentonite, beryllium, borates, brine, calc-spar, cement, auriferous cement, chalk, French chalk, clays, colemanite, kaolin, diamonds, diatomaceous earth, fahlbands, galena, gilsonite, gravel, sand, granite, graphite, guano, gypsum, gypsum cement, infusorial earth, iron, chromate of iron, oxide of iron, franklinite, isinglass, lead, black lead, carbonate of lead, lepidolite, limestone, magnesia, magnesite, marble, texicalli marble, meteorites, mica, shale, ochre, oil and gas, oil shale, onyx, opal, ozocerite, paint rock, paint stone, platinum, plumbago, resin, pumice, salines, saltpeter, sandstone, silicate, silicated rock, slate, natural slate, roofing slate, soda, carbonate of soda, nitrate of soda, sulphate of soda, stone, beds of stone, building stone, flint stone, free stone, iron stone, limestone, lithographic stone, lustral stone, stockwerke, sulphate, tailings, tin, trap rock, tungsten, umber, ulexite, volcanic ash or pumice, mineral white quartz suitable for making glass, zeolites, zinc, carbonate, silicate and sulphide of zinc, tungsten, uranium, vanadium and zirconium. See, Ricketts, American Mining Law, 4th ed. 1943, Vol I § 11. All of these minerals are "locatable" under the 1872 Mining Law, though their locatability has been constrained by a number of subsequent federal statutes, including the Mineral Leasing Act of 1920, the Materials Act of July 31, 1947, as amended by the Common Varieties Act on July 23, 1955, and the Act of September 28, 1962. In determining what minerals would be taxed, the "locatable" label complicates rather than simplifies.

The value of a mineral increases as it progresses through various processing stages, reflecting the value (and expense) added by the mine operator. A severance tax levied on the value of the mineral immediately upon severance from the ground will yield different results than a tax levied on the value of the mineral as a finished product. Depending upon the stage at which the tax is levied and the expense deductions allowed from the taxable basis, a severance tax may result in higher or lower payments, and correspondingly greater or lesser financial burdens on mineral production.

A number of states impose a severance tax on minerals in the form of carefully and completely defined statutes which set forth the basis for those taxes. The federal severance tax proposal provides no detail as to the method of calculation. Without that detail, even speculation about the revenue impact of the proposal is difficult.

A substantial percentage of the value of minerals mined in the United States is derived from mines on private lands. A severance tax on minerals extracted from public lands only would fail to capture a significant portion of the value of mineral production in the U.S. The rationale behind a severance tax only on mineral production from public lands is difficult to fathom. On the other hand, mines on private land are generally already subject to private royalties and state severance taxes. The imposition of an additional tax on those operations may render some of them unprofitable, thus potentially creating a net negative treasury impact. In addition, a tax on all lands would affect all states in which there is mining, rather than just the western states in which hard rock minerals from public lands are produced.[2] The potential effect of such a tax on states like Michigan and Minnesota, which have significant iron ore production, Missouri, which has significant lead production, Tennessee, which has significant zinc production, South Carolina, which has substantial gold production, Florida, which has significant phosphate production, New York, which has lead and silver production, and Virginia and Vermont, which have talc production, would be substantial and would likely result in some mine closures and job losses in those states.

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[2] Among the states with locatable mineral production or development targets in 1990 were: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Maine, Michigan, Minnesota, Missouri, Montana, Nevada, New Mexico, New York, North Carolina, Oklahoma, Oregon, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, Wisconsin and Wyoming. With respect to mining employment figures, we do not have detailed data on mining employment broken down by state. We do, however, have data provided by the U.S. Department of Interior, Bureau of Mines, that in 1990, the total employment in metal mining was 179,100. See Mineral Commodity Summaries 1991, U.S. Department of Interior, Bureau of Mines, p. 4. The same publication estimates 1990 employment in non-metallic minerals (except fuels) and non-fuel organic minerals at a total of 274,000. Id. at Table 1, p. 5.

2. Lack of Financial and Economic Analysis

We are aware of no detailed financial or economic analysis of the proposed severance tax. In light of the lack of detail concerning the structure of the severance tax (as discussed above), such an analysis could not be performed in any but a speculative manner. It is dangerous to project revenues from a mining tax without economic analysis. For example, one might try to estimate tax revenues from historic production estimates. That approach assumes that production levels in the hard rock minerals industry will remain constant independent of external factors other than the imposition of a severance tax. It also assumes that levels of hard rock mineral production would remain constant despite the increased production costs that would be associated with the imposition of a severance tax. We know that in the metals mining industry, taxes, fees and royalties cannot be absorbed by passing on the costs of the severance tax to consumers. In fact, the demand for most U.S.-produced hard rock minerals, for example, gold, is almost perfectly elastic. As a result, hard rock miners in most cases could not pass the additional costs imposed by a severance tax on to consumers, and would have to otherwise cover those costs by reducing expenditures. Especially over the long-term, this would result in a substantial negative economic impact, decrease in production levels, and erosion of the severance tax base.

In the short-term, it is difficult to speculate as to whether the imposition of a severance tax would cause companies to close existing mines. Over the long-term, and in light of the fact that increased costs cannot be absorbed by creating higher commodity prices, the sheer magnitude of a 12% severance tax, especially if based on gross proceeds or gross revenues, would be such that many new projects would no longer be economic and many producing mines would not be replaced once they were exhausted. It is this decrease in the investment activity of replacing existing mines that would cause a significant reduction in expenditures by the industry and concomitant negative economic impacts. Those impacts include job losses as well as reductions in expenditures. They also include lost personal and corporate income taxes which are likely ultimately to be greater than the increased revenues to the federal treasury resulting from the imposition of the tax.

Congress, of course, has already learned this lesson. The recent experience with the "luxury tax" is a good indicator of how taxes that are not passed along to consumers are detrimental to the industries they are applied to and, because of the resulting negative economic impacts, are not revenue producers. In a more recent example that directly affects the mining industry, the Congressional Budget Office estimated in its testimony of May 4, 1993 before the Subcommittee on Mineral Resources Development that 60% of all unpatented mining claims on public lands would be abandoned after the imposition of a new $100/per claim holding fee. Jan Paul Acton Testimony, p. 14. A recent article in the San Francisco Chronicle estimates that between 50% and 80% of all mining claims will be abandoned. September 1, 1993, col. A5. As a result of high levels of claim abandonment, the revenue impacts of the $100 holding fee are likely to be smaller than anticipated. This very recent experience with mining holding fees demonstrates that the mining industry cannot simply pass on the costs. Accordingly, Congress should be skeptical of the revenue-raising potential of a tax resting on the errant assumption that higher costs will not change either industry behavior or consumer behavior.

The main point here is that it is important to define the purpose of the severance tax. As a revenue raising device, the tax may or may not serve its purpose. Only a thorough economic analysis will demonstrate its success or failure on that score. If the purpose of the tax is to raise money to deposit in a fund to clean up abandoned mines or Superfund sites (two very different problems), the Committee should avoid committing funds before it has defined the problem. In Burden of Gilt, a broadside published by the Mineral Policy Center ("MPC") on July 20, 1993, the MPC called for creation of a federal hardrock abandoned mine cleanup fund. The MPC report was an advocacy piece by a special interest group. It was dramatic and insistent. It was also misleading. The MPC report asserts that the mining industry is practically unregulated. The report asserts that vast sums (approximately $71.5 billion) are necessary to clean up the mess that mining has made. In his excellent September 9, 1993 critique of the MPC report, Steve Barringer of Holland & Hart pointed out that MPC's cost estimates for cleanup of abandoned mine sites are not only undocumented, but erroneously include the cost of cleaning up Superfund sites, which have already been funded under the Superfund laws. As Mr. Barringer points out, this double counting drastically inflates the MPC's estimated cost of abandoned mine cleanup operations. In conclusion, the Committee is considering proposing a tax whose terms are undefined, and the purpose of which is murky, at best.

The problem of abandoned mines on public lands deserves careful study and deliberate analysis. We must first enlist the States in building an inventory of sites and establishing reclamation goals and priorities. Next, we must consider private side cleanup scenarios, before we saddle the public with a reclamation burden. For example, we could dramatically reduce the public burden by encouraging private remining of old abandoned sites. Remining could generate economic activity at a profit and still fund reclamation.

Abandoned mine reclamation is a complex problem with a complex solution. It is a terrible mistake to create a new tax to fund a program we have not yet defined.

3. An Economic Analysis Is Critical in Estimating the Net Revenue Impact of the Proposal

It is impossible to predict the impact of the proposed severance tax without applying that tax to real numbers from existing hard rock mineral projects, estimating changes in output resulting from the increased costs associated with the tax, and then using those changes in output to derive the input to the Department of Commerce's Regional Input-Output Multiplier system ("RIMS"). Application of the RIMS multipliers to the changes in output allows for an estimate of the economic impact of such a tax.

To perform such an analysis on the proposed severance tax, one would have to calculate the impacts of that tax on a representative sample of hard rock mining projects during a given year, extrapolate those numbers up to determine state-wide and industry-wide impacts, and then determine the economic impacts (in terms of job losses, declines in revenue and reduction of economic output) through application of the RIMS multipliers. Such an analysis can be designed to avoid risky projections about future trends and production performance. It can instead be constructed using a model reflecting the U.S. mining industry as it actually existed in a particular year. The analysis would then look at the financial and economic impacts of the proposed tax on the mining industry as it actually existed in the year selected, based on actual price, cost, and production data collected from individual mining companies. From that "snapshot" of the industry one would then be able to infer what the industry would look like going forward. That method will allow for an analysis of the impacts of the proposed tax over the longer term, and also for a determination of which particular projects never would have begun because they would have been rendered uneconomic by the new tax.

In performing that analysis, all of the guidelines listed below should be followed:

- The analysis should use long-term, rather than short-term, estimates in deriving the impacts of the proposed tax. The investments in the hard rock minerals industry are relatively long-term in nature, with project lives averaging from 5 to 30 years. As a result, it is necessary to evaluate the impact of the proposed tax over a time span that corresponds to the investment horizon of the industry.

- The analysis should utilize actual financial and production data from U.S. mining operations.

- The analysis should account for the regional differentiation of the industry. For example, Colorado does not produce a lot of hard rock minerals these days, but the presence of national and regional mining company headquarters makes mining important to Colorado. Emphasizing regional differentiation recognizes that resource reallocation between states or regions or out of the mining industry into other industries is unusual at best, even over the long term. That is especially true with capital and labor resources. Barriers to resource reallocation will be even greater in this case, because a severance tax affects all projects in all states. Workers displaced in Nevada will not find mining jobs in mines in California because miners will be displaced everywhere.

- In estimating loss of output, the analysis should consider the reductions in expenditures and employment beyond the impacts on operating mining projects; e.g., exploration, development and construction.
- The analysis should consider the net effect on treasury receipts, including:
  - Loss of personal income taxes related to lost earnings,
  - Loss of corporate income taxes from increased costs and non-viable projects,
  - Federal administrative costs for both administering the implementation and collection of the tax.

4. Negative Impact Likely

As shown in the April 30, 1993 study by Coopers & Lybrand and Morrison & Foerster, entitled "A Comparative Analysis of Mining Fees and Royalties" (the "1993 Study"), a poorly designed federal royalty, and presumably a federal severance tax, can have dramatic negative effects on the federal treasury. As shown in the 1993 Study, the 8% royalty on gross proceeds plus the holding fees proposed in the 1993 Bumpers Bill would likely result in a $443 million net loss to the federal treasury. The 8% royalty plus the holding fees proposed in the 1993 Rahall Bill would result in a $422 million net loss to the federal treasury. (See Table 2 of the 1993 Study). In performing a sensitivity analysis on the 1993 Bumpers and Rahall Bill royalties, assuming the holding fee remains the same, the study team concluded that if the Bumpers and Rahall royalties were 12.5%, the net loss to the federal treasury would be $527 million under the Bumpers Bill and $472 million under the Rahall Bill. (See Table 2 of the 1993 Study). The 1993 Craig Bill proposed a 2% royalty on net income at the mouth of the mine. Our study showed that at a 12.5% rate, the Craig royalty plus holding fees would net the federal treasury only $22 million.

Although the severance tax proposal is far too vague to afford any guidance on the question of net treasury impacts, a comparison of the net treasury impacts of the 1993 Bumpers and Rahall Bill royalties and the 1993 Craig Bill royalty should be instructive. A federal severance tax in the form of Nevada's net proceeds tax is likely to net the treasury more than a severance tax on gross proceeds or gross income; however, either form of severance tax is likely to have significant negative effects on the mining industry.

More importantly, our 1993 Study only analyzed the impacts of a gross and net royalty on public lands in 12 western states. A federal severance tax on all lands, public and private, and on minerals found in all states would be likely to have a more dramatically negative net treasury impact. A severance tax applicable to public lands only may insulate all but the western states from direct negative consequences of mine closures. A severance tax applicable to all lands, however, would affect every state with an active mine. Job losses and mine closures in every state may well have an even more dramatic negative net treasury impact than shown in our 1993 Study.

Mr. PAYNE. Mr. Kelly.

STATEMENT OF JOHN L. KELLY, VICE PRESIDENT, PUBLIC AFFAIRS, CLEVELAND CLIFFS, INC., ON BEHALF OF THE AMERICAN IRON ORE ASSOCIATION

Mr. KELLY. Mr. Chairman and distinguished members of the subcommittee, I appreciate the opportunity to appear before you. I am John Kelly. I am vice president of public affairs, Cleveland-Cliffs, Inc. I am also a former tax committee chairman of American Iron Ore Association headquartered in Cleveland, which I represent here today. The association is a trade organization representing companies that mine approximately 70 percent of the iron ore that is produced in the United States and Canada.

I am here to convey to you in the strongest terms possible that iron ore producers are deeply troubled that a mineral severance tax has been proposed and moreover, upset that it would apply to iron ore mining. We fail to see the rationale or need for such a tax and we cannot afford this new tax burden at any percentage level.

My remaining testimony will focus on our industry profile in the hope that your understanding of our contribution to society and our economic challenges will be enhanced.

Essentially there are no remaining iron ore reserves of commercial grade in the United States, but huge quantities of low grade material exist in northern Michigan and Minnesota. Presently there are nine iron ore mining operations in these two areas that are efficiently producing more than 50 million annual tons of high quality iron ore pellets from low grade deposits.

These operations and the related infrastructure represent several billion dollars of fixed investment. Steel mills are the only consumers of iron ore pellets and the iron ore industry is indispensable to the survival of our basic steel industry.

The iron content of low grade ore is 36 percent or less. These deposits are not suitable for any commercial use. Pellets, on the other hand, contain approximately 65 percent iron. To the extent they remain competitive in cost, they are a desirable raw material for making iron and steel products because they consistently meet demanding physical and chemical specifications. Due to transportation limitations and other reasons, our pellets generally do not enter markets outside the Great Lakes steel-producing regions of the United States and Canada.

Global conditions in the iron ore and steel industries over the past decade have kept downward pressure on prices and have necessitated intense efforts to increase quality and decrease costs. Yet, iron ore is being sold below cost on a spot market basis; and integrated steel producers continue to report losses and weak earnings. Under these conditions, a severance tax on U.S. iron ore mining operations cannot be passed on to consumers and it cannot be absorbed by producers without substantial negative implications.

The northern regions of Michigan and Minnesota are as sparsely settled and are noted for persistently high unemployment. Iron ore mining represents the predominant source of employment for a highly skilled and highly paid work force; and it generates considerable satellite employment. Negative consequences to iron ore pellet producers, brought about by a severance tax, can also be expected to have serious implications for surrounding communities in these two States.

Mining is uniquely risky business; yet over the past two decades, we have invested billions of dollars in state-of-the-art pelletizing plants and related facilities. These investments were made with the expectation that a reliable and stable U.S. tax system would continue to provide essential incentives to help bring an adequate return on these long-term investments.

Our expectations were strengthened by enactment of the Minerals Policy Acts of 1970 and 1980, both of which support minerals development and enhanced minerals availability as a matter of national policy. Yet our tax system has worsened over the past decade as it pertains to basic industry, and costs of new Government mandates have not helped the situation.

To now be confronted with another proposed tax system change in the form of a national severance tax, which is in conflict with national minerals policy, is beyond our ability to understand or reconcile.

It is necessary to provide tax incentives to invest in domestic basic industries that continue to be ravaged by economic depression and threatened by foreign dumping and subsidies.

The domestic iron ore mining and steel industries compete with foreign suppliers that benefit from border taxes on imported products and tax credits on their own exports. Domestic prices of iron ore mining and steel have languished for more than a decade and higher costs cannot be absorbed.

While this is not the forum in which to discuss wholesale alteration of the U.S. tax system, you should know that both of these industries have advocated prompt consideration and adoption of an equitable GATT-legal and border-adjustable tax on U.S. business activities as a substitute for the present tax on business income.

We ask you to reject the mineral severance tax proposal so as not to exacerbate the major shortcomings of our Nation's existing business tax system. In doing so, you will also assist the President in his renewed effort to stimulate the economy.

Thank you for your attention.

Mr. PAYNE. Thank you very much.

[The prepared statement follows:]

STATEMENT
of
AMERICAN IRON ORE ASSOCIATION

before the
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS

September 8, 1993

SUBJECT: PROPOSAL TO IMPOSE A SEVERANCE TAX ON HARD ROCK MINERALS

Mr. Chairman and other distinguished members of this Subcommittee, I appreciate this opportunity to appear before you. My name is John Kelley, Vice President-Public Affairs, Cleveland-Cliffs Inc. I am also former Tax Committee Chairman of American Iron Ore Association, headquartered in Cleveland, Ohio, which I am representing here today. The Association is a trade organization representing companies that mine approximately 70% of the iron ore that is produced in the United States and Canada.

My purpose in requesting to be heard is to convey to you in the strongest terms possible that iron ore producers are deeply troubled that a minerals severance tax has been proposed and, moreover, upset that it would apply to iron ore mining. We fail to see the rationale or need for such a tax; and we cannot afford this new tax burden at any percentage level.

Because the severance tax concept is not complicated and our resistance is grounded in the need for a strong and world competitive domestic iron ore mining industry, my remaining testimony will focus on our industry profile in the hope that your understanding of our contribution to society and our economic challenges will be enhanced.

Essentially, there are no remaining iron ore reserves of commercial grade in the United States, but huge quantities of low grade material exist in northern Michigan and Minnesota. Presently, there are nine iron ore mining operations in these two areas that are efficiently producing more than 50 million annual tons of high quality iron ore pellets from low grade deposits. These operations and related infrastructure represent several billion dollars of fixed investment. Steel mills are the only consumers of iron ore pellets, and the iron ore industry is indispensable to the survival of the basic steel industry.

The iron content of low grade ore ranges from less than 30% to approximately 36%. These deposits are not suitable for steel industry consumption or any other use. Pellets, on the other hand, contain approximately 65% iron. The transformation of low grade iron ore into pellets is a very expensive process in the United States because of high energy, labor and environmental costs. To the extent they remain competitive in cost, they are a desirable raw material for making iron and steel products because they consistently meet demanding physical and chemical specifications. Due to transportation limitations and various other reasons, however, these domestically produced pellets generally do not enter markets outside the Great Lakes steel producing regions of the United States and Canada, except for minor movements to steel producers in such areas as Utah and Alabama. In contrast, foreign competition does exist for the U.S. market, notably from Brazil which mines a very high grade ore requiring no expensive processing.

Global conditions in the iron ore and steel industries over the past decade have kept downward pressure on prices and have necessitated intense efforts to increase quality and decrease costs. Yet, iron ore is being sold below cost on a spot market basis; and integrated steel producers continue to report losses and weak earnings. Under these conditions, a severance tax on U.S. iron ore mining operations cannot be passed on to consumers; and it cannot be absorbed by producers without substantial negative consequences.

The northern regions of Michigan and Minnesota are sparsely settled and are noted for persistently high unemployment. Iron ore mining, which has been forced to rationalize its operations considerably in recent years, represents the predominant source of employment for a highly skilled and highly paid work force; and it generates considerable satellite employment. Negative consequences to iron ore pellet producers, brought about by the imposition of a severance tax, can also be expected to have serious implications for surrounding communities in these two states, because of reduced production and the probability that some operations would have to close.

It is generally recognized that mining is an extremely risky business. Yet, over the past two decades we have invested billions of dollars in state-of-the-art pelletizing plants, related facilities, modern self-unloading lake vessels, and other infrastructure, primarily for domestic trade. These investments were made with the expectation that a reliable and stable U.S. tax system would continue to provide essential incentives to help bring an adequate return on these long-term fixed investments. Understandably, our expectations were strengthened by enactment of the Mining and Minerals Policy Act of 1970 and the Materials and Minerals Policy Act of 1980, both of which are in support of minerals development and enhanced minerals availability as a matter of national policy. Yet, our tax system has worsened over the past decade as it pertains to basic industry, and costs of new government mandates have not helped the situation. To now be confronted with another proposed tax system change in the form of a national severance tax, which could bring about results that are directly in conflict with existing minerals policy as enacted by Congress, is beyond our ability to understand or reconcile.

The bottom line is, our industry experienced an abrupt and severe business contraction over the past decade, and our present economic condition remains bleak. This is greatly due to unfair trade practices by offshore competitors and competition generally on a global scale.

To carry out our existing national policy, it is urgently necessary to provide through our tax system incentives to invest in domestic industries that continue to be ravaged by economic depression and threatened by foreign dumping and subsidies. The question today is not growth or expansion; it is tax stability and incentives for survival of vital basic industries in this country.

The domestic iron ore mining and steel industries compete directly in domestic markets and elsewhere with foreign suppliers that benefit from border taxes on imported products and tax credits on their own exports. Domestic prices of iron ore and steel have languished for more than a decade, and higher tax costs cannot be absorbed. We recognize that this is not the forum in which to discuss wholesale alteration of the U.S. tax system, but we believe you should know that both of these industries have advocated prompt consideration and adoption of an equitable, GATT-legal, and border-adjustable tax on U.S. business activities, as a substitute for the present tax on business income.

The request we present to you today is to reject the minerals severance tax proposal, so as not to exacerbate the major shortcomings of our nations's existing business tax system.

Mr. PAYNE. We have been called to vote so the committee will be in recess until 2:30.

[Brief recess.]

Mr. PAYNE. The committee will come to order.

We had concluded with the testimony of our fifth panel and were preparing to ask questions of the witnesses.

Mr. Hancock will inquire.

Mr. HANCOCK. Thank you, Mr. Chairman. I have several questions I would like to ask just generally.

Is there a specific proposed tax on mining? If there is, I haven't seen it. Is it in writing any place?

Mr. ALFERS. I haven't seen one either, Mr. Hancock.

Mr. HANCOCK. It will be difficult to evaluate it until we see what it is.

Mr. ALFERS. It makes it difficult to speculate what the revenue or economic impact might be. It is terribly important to nail down what this proposal is to give it any kind of consideration.

Mr. HANCOCK. We are talking about a tax; I understand that. It seems like that is what we talk about here most of the time. We don't know how it would be applied. We don't know for sure what would be subject to the tax. We don't know how it would be collected.

Mr. Chairman, we might be premature in holding a hearing on something we haven't seen. Has there been a tax revenue estimate prepared and if so——

Mr. ALFERS. I have seen none.

Mr. KELLY. I don't think there has. I would think it would be extremely difficult for anyone to make a reliable estimate.

Mr. HANCOCK. OK. I understand that prices of metals and materials are determined on the world market. It seems we think they aren't at times.

Wouldn't any type of a tax on minerals put us at an international competitive disadvantage, right now especially?

Mr. ALFERS. I think any tax becomes a cost in the final analysis and some taxes become a bigger cost than others. A tax on the gross value of minerals, for example, can swallow the entire margin. Consider the idealized example of the production of an ounce of gold. In North America, the average cost of production per ounce of gold is about $330. If the price of gold is $360, we are looking at a $30 margin.

If one calculates the tax or even a royalty on the gross value of that product, it more than swallows all the margins, about 140 percent of the operating margin. Something like that is obviously untenable. The reason for that is that the economics of mining, the margins are very, very thin. Often a mine will try to operate sometimes at a loss for awhile, but on a margin of 80 or 90 percent. So taxes of the magnitude that we are looking at here are wholly inappropriate to an industry like this.

Mr. HANCOCK. Well, do you have any idea of what the total number is of how many different companies do mining and oil exploration?

Mr. ALFERS. In mining, there must be several thousand companies that are engaged at some level in the exploration or prospecting, development of mining.

Mr. HANCOCK. Do you have any idea of the number of people engaged in the mining industry, the amount of employment?

Mr. ALFERS. I would like to provide you a memorandum that would lay out the distribution of those jobs. I don't have that on the tip of my tongue.

[The information follows:]

MORRISON & FOERSTER

SAN FRANCISCO
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SACRAMENTO
ORANGE COUNTY
PALO ALTO
WALNUT CREEK
SEATTLE

ATTORNEYS AT LAW

5200 REPUBLIC PLAZA
370 17TH STREET
DENVER, COLORADO 80202-5638
TELEPHONE (303) 592-1500
TELEFACSIMILE (303) 592-1510

NEW YORK
WASHINGTON, D.C.
LONDON
BRUSSELS
HONG KONG
TOKYO

DIRECT DIAL NUMBER
(303) 592-2265

April 14, 1994

VIA FACSIMILE

The Honorable Mel Hancock
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth HOB
Washington, DC 20515-6348

Re: Employment in the Mining Industry

Dear Representative Hancock:

On September 8, 1993, I testified on behalf of the Mineral Resources Alliance at hearings held by the Subcommittee on Select Revenue Measures of the House Ways and Means Committee. The subject of those hearings was miscellaneous revenue measures, among which was a proposed excise tax on the extraction of hard rock minerals. At the hearing, you asked for information on the number of mining entities, including the oil and gas industry, in the United States. You also inquired as to the number of people employed by the mining industry.

The most current complete set of government figures on employment in the mining industry and the number of enterprises involved in the mining industry come from 1987.[1] The total number of entities engaged in mining activities ("Establishments") in 1987 was 33,617. Broken down, that number included 1,027 establishments in the metal mining industry; 5,775 establishments in the nonmetallic mining industry; 3,905 establishments in the coal mining industry; and 22,910 establishments in the oil and gas extraction industry.

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[1] The remainder of the information in this and the following paragraphs comes from the charts attached hereto as Exhibits A and B, reprinted from the U.S. Department of Commerce, Bureau of the Census, Statistical Abstract of the United States 1993, 694 (1993) (Exhibit A), and the U.S. Department of Labor, Bureau of Labor Statistics, Employment and Earnings 86 (January 1994) (Exhibit B).

In terms of employment, in 1987 there were 698,000 people directly employed by the mining industry. Of those, the metal mining industry employed 44,000; nonmetallic mining employed 113,000; the coal industry employed 163,000; and the oil and gas extraction industry employed 378,000. For November of 1993, that overall employment figure dropped from 698,000 to 598,000. In November of 1993, the metal mining industry employed 50,600 people; nonmetallic mining employed 101,400; the coal industry employed 94,600; and the oil and gas extraction industry employed 351,200.

During the six-year period, only the metal mining industry saw an increase in employment. The metal mining industry, which includes gold, silver, copper, lead and zinc, is the industry that mines most of the minerals that are subject to appropriation under the 1872 Mining Law and which would, in turn, be subject to the proposed excise tax. In addition, some of the minerals included in the nonmetallic minerals category are subject to the 1872 Mining Law and would be subject to the proposed excise tax as well.

It is also important to bear in mind that the mining industry is extraordinarily productive in creating indirect jobs. The mining industry creates service and support jobs that are not reflected in the employment figures reported above. Economists often use the Regional Input-Output Modeling System ("RIMS") developed by the Bureau of Economic Analysis to determine the indirect jobs created by a particular industry in a particular state. For the mining industry in the 12 western states (where the vast majority of metal mining occurs), that multiplier averages 19.3073 (in other words, a total of 19 jobs are created for every $1,000,000 of output from the mining industry). It is both the direct and indirect jobs that would be impacted by the imposition of an excise tax.

By way of illustration, in 1993, we, along with Coopers & Lybrand, conducted a study on the financial and economic impacts of various royalty proposals on the hard rock mining industry.[2] The results of that study highlight both this job-creating aspect of the mining industry and, conversely, the job loss threatened by the new fees, royalties, and taxes recently imposed on or now proposed for the mining industry. Our study indicated that the hard rock mining industry would employ 47,000 fewer people over the long term as a result of the imposition of an 8% gross royalty on production. It is the possibility of impacts of that magnitude that demands a thorough economic analysis of proposals like the one for a 12% excise tax that was the subject of the hearing.

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[2] Alfers & Graff, A Comparative Analysis of Mining Fees and Royalties (1993).

If we can be of any assistance to the Subcommittee in performing such an economic analysis, please contact me. Thank you again for the opportunity to testify before the Subcommittee.

Very truly yours,

Stephen D. Alfers

SDA:je
Enclosures

EXHIBIT A

No. 1184. Mineral Industries—Summary: 1977 to 1987

["N.e.c." means not elsewhere classified. See also *Historical Statistics, Colonial Times to 1970*, series M1-12]

MINERAL INDUSTRY	1977			1982					1987									
	Establishments	All employees, payroll[1] (mil. dol.)	Value added in mining[2] (mil. dol.)	Establishments		All employees		Value added in mining[2] (mil. dol.)	Establishments		All employees		Production workers[4]			Value added in mining[2] (mil. dol.)	Value of shipments and receipts[6] (mil. dol.)	Capital expenditures (mil. dol.)
				Total	With 20 or more employees	Number[3] (1,000)	Payroll[1] (mil. dol.)		Total	With 20 or more employees	Number[3] (1,000)	Payroll[1] (mil. dol.)	Number[3] (1,000)	Hours[5] (millions)	Wages (mil. dol.)			
All industries	31,359	13,167	68,013	[7]42,241	(NA)	1,114	26,637	186,058	33,617	6,290	698	21,730	451	942	12,443	110,959	157,964	15,418
Metal mining	1,208	1,486	3,504	1,434	(NA)	68	1,860	3,218	1,027	290	44	1,354	34	68	952	4,610	6,852	899
Iron ores	97	3	1,046	78	40	12	340	770	61	16	7	224	6	11	166	768	1,362	24
Copper ores	133	544	1,067	81	51	22	604	672	61	33	14	405	11	21	283	1,301	2,150	205
Lead and zinc ores	88	105	329	71	26	4	112	201	39	19	2	58	1	3	40	176	288	12
Gold and silver ores	175	71	161	371	80	10	263	650	372	101	13	423	10	21	305	1,614	2,281	555
Ferroalloy ores, except vanadium	58	107	256	69	16	5	150	146	68	10	1	46	1	2	24	61	110	6
Metal mining services	270	52	112	313	(NA)	3	61	90	268	42	3	81	2	5	60	176	251	26
Miscellaneous metal ores	387	234	533	451	91	12	332	686	178	42	4	116	3	5	75	313	449	70
Coal mining	5,451	4,171	11,266	5,087	(NA)	251	6,805	16,631	3,905	1,418	163	5,567	129	259	4,251	17,068	25,956	1,665
Bituminous coal and lignite mining	4,944	4,005	10,837	4,513	1,767	241	6,570	16,041	3,507	1,335	158	5,410	124	249	4,125	16,679	25347	1,614
Anthracite mining	156	48	116	152	40	3	67	172	107	26	2	41	2	3	32	109	206	12
Coal mining services	351	119	313	422	(NA)	7	166	418	291	67	4	116	3	7	94	280	402	39
Oil and gas extraction	18,447	5,902	48,587	29,974	(NA)	685	15,693	159,937	22,810	3,167	378	11,961	206	437	5,283	80,048	112,363	11,717
Crude petroleum and natural gas	8,573	2,738	38,327	[7]12,087	(NA)	264	6,084	126,035	10,203	1,171	199	7,510	69	142	2,154	67,955	76,518	10,548
Natural gas liquids	692	227	3,286	793	236	14	402	8,865	714	210	13	433	10	20	320	4,025	24,750	383
Oil and gas field services	9,182	2,936	6,974	[7]17,094	(NA)	406	9,207	25,037	11,893	1786	167	4,018	127	275	2,809	8,069	11,095	786
Drilling oil and gas wells	2,625	1,317	3,307	4,385	(NA)	166	4,007	11,316	2,591	620	65	1,318	46	93	1,012	2,549	3,626	321
Oil, gas exploration services	1,252	220	545	2,934	(NA)	42	810	2,307	1,017	143	17	452	13	27	311	771	1,096	69
Oil, gas field services, n.e.c.	5,305	1,399	3,122	9,775	(NA)	199	4,391	11,416	7,485	1,023	85	2,248	69	154	1,486	4,748	6,373	395
Nonmetallic mining	6,256	1,609	4,656	5,746	(NA)	110	2,278	6,273	5,776	1,464	113	2,858	83	178	1,956	9,233	12,796	1,136
Dimension stone[8]	209	19	39	154	22	2	21	60	149	19	1	25	1	2	16	65	66	4
Crushed and broken stone[8]	2,055	543	1,501	1,932	667	37	701	1,787	2,002	711	44	1,082	33	72	754	3,465	4,768	521
Sand and gravel[9]	2,807	416	1,017	2,758	343	28	520	1,336	2,760	436	33	772	24	51	551	2,320	3,139	236
Clay and related minerals[9]	255	136	358	224	97	11	212	510	197	100	10	272	7	15	165	827	1,249	111
Chemical and fertilizer minerals	205	372	1,433	196	114	26	681	2,237	146	79	16	501	12	24	336	1,999	2,772	192
Nonmetallic minerals, services	176	36	70	167	(NA)	2	36	70	177	23	2	45	1	3	32	119	165	25
Miscellaneous[9]	548	67	238	315	72	6	109	263	352	66	7	162	6	10	101	438	618	46

NA Not available. [1] Gross earnings paid to all employees on payroll. [2] Computed by subtracting cost of supplies, minerals received for preparation, purchased fuel and electric energy, contract work, and purchased machinery from the value of shipments and capital expenditures. [3] Excludes proprietors and firm members of unincorporated concerns. [4] Represents employees up through the working foreman level engaged in manual work. Includes development and exploration workers. [5] Excludes paid vacations, holidays, and sick leave; includes actual overtime hours (not straight-time equivalent). [6] Represents value of shipments of primary and secondary products of the industry and amount received for services performed for other establishments on a contract, fee, or other basis. [7] Redefined to conform to 1987 and pre-1982 definition of establishment; for detail, see source. [8] Excludes data for dimension stone quarries operated in conjunction with dressing plants. [9] Excludes data for mining included in establishments classified in manufacturing industries.

Source: U.S. Bureau of the Census, *Census of Mineral Industries: 1977, 1982, and 1987*, final industry series reports.

EXHIBIT B

ESTABLISHMENT DATA
EMPLOYMENT
NOT SEASONALLY ADJUSTED

B-2. Employees on nonfarm payrolls by detailed industry

(In thousands)

Industry	1987 SIC Code	All employees					Production workers[1]				
		Nov. 1992	Dec. 1992	Oct. 1993	Nov. 1993[p]	Dec. 1993[p]	Nov. 1992	Dec. 1992	Oct. 1993	Nov. 1993[p]	Dec. 1993[p]
Total		109,865	109,856	111,531	111,803	111,803	-	-	-	-	-
Total private		90,698	90,763	92,374	92,494	92,550	73,742	73,833	75,348	75,456	75,455
Mining		620	613	600	596	604	441	434	424	423	426
Metal mining	10	52.4	51.7	50.9	50.6	-	41.2	40.8	41.0	40.7	-
Iron ores	101	8.5	8.5	10.2	10.0	-	6.5	6.6	8.4	8.2	-
Copper ores	102	15.1	15.1	14.6	14.9	-	12.4	12.4	12.3	12.4	-
Coal mining	12	121.1	118.5	94.5	94.8	-	97.6	95.7	73.4	73.3	-
Bituminous coal and lignite mining	122	112.5	110.1	86.3	86.7	-	90.7	88.7	66.6	88.5	-
Oil and gas extraction	13	343.2	344.3	351.8	351.2	347.1	224.4	224.4	231.7	232.0	-
Crude petroleum and natural gas	131	172.5	172.0	164.0	163.9	-	86.9	85.6	79.6	80.3	-
Oil and gas field services	138	165.2	166.5	162.3	161.9	-	133.0	134.2	147.7	147.5	-
Nonmetallic minerals, except fuels	14	103.0	98.4	102.8	101.4	-	77.5	72.9	78.1	76.6	-
Crushed and broken stone	142	38.2	36.9	38.9	38.6	-	29.5	26.2	30.7	30.4	-
Sand and gravel	144	33.4	30.6	34.0	33.2	-	-	-	-	-	-
Chemical and fertilizer minerals	147	14.7	14.4	12.9	12.9	-	-	-	-	-	-
Construction		4,572	4,383	4,874	4,775	4,576	3,523	3,344	3,819	3,719	3,523
General building contractors	15	1,069.4	1,039.1	1,101.6	1,092.0	1,072.1	759.1	731.3	789.0	780.6	-
Residential building construction	152	524.8	509.1	539.2	536.3	-	358.0	344.4	369.7	368.0	-
Operative builders	153	26.5	26.6	27.3	27.3	-	12.0	12.1	11.5	11.6	-
Nonresidential building construction	154	518.1	503.4	535.3	528.4	-	389.1	374.6	407.6	401.2	-
Heavy construction, except building	16	743.5	668.4	787.8	748.0	-	621.5	548.0	668.9	630.1	-
Highway and street construction	161	224.4	182.3	267.0	244.0	-	185.1	143.8	226.9	203.9	-
Heavy construction, except highway	162	519.1	486.1	520.8	504.0	-	436.4	404.2	442.0	426.2	-
Special trade contractors	17	2,759.2	2,675.6	2,984.6	2,934.9	-	2,142.1	2,064.2	2,360.6	2,308.4	-
Plumbing, heating, and air conditioning	171	609.4	604.9	637.8	630.5	-	443.0	439.4	470.6	462.3	-
Painting and paper hanging	172	159.8	151.5	186.2	178.3	-	131.6	123.6	157.7	149.3	-
Electrical work	173	502.6	502.0	524.1	525.2	-	367.8	367.5	407.3	408.0	-
Masonry, stonework, and plastering	174	413.4	388.0	443.5	434.2	-	354.1	329.0	382.2	372.4	-
Carpentry and floor work	175	172.0	169.9	182.0	180.9	-	126.1	125.1	137.4	136.8	-
Roofing, siding, and sheet metal work	176	197.9	192.5	220.6	216.1	-	157.1	151.4	179.2	176.7	-
Manufacturing		17,994	17,926	17,635	17,803	17,745	12,237	12,186	12,207	12,184	12,130
Durable goods		10,186	10,152	10,044	10,052	10,041	6,788	6,767	6,749	6,759	6,761
Lumber and wood products	24	681.1	676.9	698.5	695.5	691.3	559.9	555.5	577.1	573.5	569.6
Logging	241	78.5	76.6	79.7	77.3	-	64.6	62.8	65.8	63.5	-
Sawmills and planing mills	242	176.7	176.6	177.4	176.4	-	153.1	153.0	153.7	153.1	-
Sawmills and planing mills, general	2421	141.4	141.2	141.6	140.5	-	122.2	122.0	122.6	121.9	-
Hardwood dimension and flooring mills	2426	33.3	33.3	33.7	33.6	-	29.2	29.2	29.4	29.5	-
Millwork, plywood, and structural members	243	242.6	240.7	249.6	249.5	-	194.4	192.3	201.0	200.3	-
Millwork	2431	101.0	100.0	103.2	103.6	-	78.6	77.7	80.6	80.6	-
Wood kitchen cabinets	2434	67.4	67.2	69.2	69.7	-	53.2	53.1	55.4	55.6	-
Hardwood veneer and plywood	2435	22.3	22.1	22.9	22.8	-	19.2	19.0	19.6	19.5	-
Softwood veneer and plywood	2436	27.3	27.3	27.1	26.6	-	24.6	24.5	24.5	23.9	-
Wood containers	244	42.6	42.1	43.9	44.2	-	35.9	35.3	37.3	37.6	-
Wood buildings and mobile homes	245	59.5	59.5	65.9	66.0	-	46.2	46.1	52.0	52.1	-
Mobile homes	2451	43.3	43.6	49.4	49.7	-	36.0	36.2	41.3	41.5	-
Miscellaneous wood products	249	80.8	81.2	82.0	82.1	-	65.7	66.0	67.3	66.9	-
Furniture and fixtures	25	479.6	478.8	485.5	486.5	486.6	378.4	378.0	384.6	385.3	385.1
Household furniture	251	272.4	273.1	274.4	275.4	-	227.2	227.7	229.6	230.6	-
Wood household furniture	2511	121.8	122.4	122.5	122.6	-	104.5	105.0	105.2	105.8	-
Upholstered household furniture	2512	87.5	87.6	88.1	89.0	-	72.6	73.1	73.6	74.6	-
Metal household furniture	2514	20.6	20.3	20.2	20.6	-	16.6	16.3	16.5	16.9	-
Mattresses and bedsprings	2515	28.3	28.5	29.6	29.2	-	21.6	21.6	22.6	22.2	-

See footnotes at end of table.

Mr. HANCOCK. Would you say the severance tax would force some mines to close or do you think that the marketplace would be able to absorb the severance tax they are talking about?

Mr. ALFERS. Some mines would close and others would change their shape in a way that would be similar to closing. What we have not done though is looked at the economics of a tax proposal, because we haven't seen that. We have, however, in the context of the reform looked pretty hard at the economics of mining projects in the United States, and we have looked at royalties in that context. We are able to on a project-by-project basis look at the way royalty schemes affect the operations, and some mines close.

It is important here because mining is one of those industries where there is a tremendous capital investment to build a mine. Costs can be sunk. So to just think about the closure of a mine in the short run grossly understates the economic impact.

It is the mines over a longer term, those mines that are on the table if you will, those in the midst of feasibility that are approaching a construction decision where the capital is not sunk, those will stop, and in our economic analysis that is where we saw the big jobs impact.

Mr. HANCOCK. On August 6, I think it was, we passed a major tax increase. I am sure you are associated with small business companies. What kind of feedback are you getting from them now about these changes? Are you getting the same feedback from your members as I am getting in my district about the new tax law?

Mr. CAMPBELL. I can't comment for small business, but as a large corporation, our tax rate has gone up and certainly the overall fact, both from a corporate standpoint as well as personal, there is a tremendous outcry at least to the people I am in contact with as far as the new tax law is concerned.

Mr. HANCOCK. But you do business with a lot of small business people?

Mr. CAMPBELL. Absolutely, yes.

Mr. HANCOCK. What are those people telling you?

Mr. CAMPBELL. Congressman, I haven't found any support. Nobody is pleased with it.

Mr. HANCOCK. Thank you very much.

Mr. PAYNE. Mr. Hoagland.

Mr. HOAGLAND. No questions.

Mr. PAYNE. Mr. McCrery.

Mr. MCCRERY. Thank you, Mr. Chairman.

Mr. Damron, is your major objection to an import fee that U.S. manufacturers would be at a disadvantage in terms of energy costs? Is that your basic objection?

Mr. DAMRON. That is basically it, competitiveness worldwide.

Mr. MCCRERY. That is a legitimate point.

Mr. Campbell and Ms. Lazenby, how do you answer that objection?

Ms. LAZENBY. If you look at Japan they have an 85 percent custom fee for imported oil. We are not asking for a very large amount. EC imposes a customs fee so I don't think the amount is such that it would make the chemicals noncompetitive. We are asking for something that protects American jobs. We are getting

$14.50 for our oil that we sell and it costs $12 a barrel to operate that oil. We have to pay royalty.

So right now, we are losing almost $2 a barrel on the oil that we produce. We can't survive, and you are going to lose 12 million barrels of oil, certainly at least a million, and that is $7 billion more. Surely we can come up with something that will protect 100,000 jobs.

Mr. McCrery. Mr. Campbell.

Mr. Campbell. Congressman, I think there are a couple of overriding issues. First, it really is in the best interest of this country, I think, to have a strong exploration and production industry and refining and marketing industry. I really believe that. Second, there is a difference between the crude oil import fee and the refined product fee that I was talking about.

In the case of the crude oil fee, the world is awash in crude oil. It is today and if you look at conservation, alternative fuels, reformulated gasoline and oxygenates, the world will be awash in crude oil for a long time.

Any import fee that you put on crude oil increases the cost of energy in this country. We can talk about the amount, but that is the impact. In the case of the refined product fee, there is a big difference. When the Congress passed the regulatory laws that we are living with today, you already raised the cost to manufacture a product in this country.

You have created that high cost product island versus the rest of the world. We are talking about the ability of foreign manufacturers to undercut that because they aren't playing by the same rules. So the higher cost product has already been created by the regulations and laws recently passed.

Mr. McCrery. I don't disagree with that, but that is not necessarily a reason to exacerbate the problem. I mean, I share Mr. Damron's concern and I am from Louisiana, so I certainly share the concern of the independent producers.

We have already lost somewhere between 450,000 and 600,000 jobs depending on whose estimates you believe, so another 100,000 may not seem too critical. But certainly those of us in the energy producing states would like to preserve what we have left and even create more. The way to do that obviously is to get the price up.

So I am kind of stuck between the concerns of our manufacturing sector and the concerns of the producing sector. What about an import fee tied to a peg price, put on a sliding scale, so that if the world price drops below the peg price, the import fee would kick in? Let's say we establish a peg price of $21 a barrel. If the world price is $17, there is a $4 import fee. Have you considered that?

It seems to me that may encourage OPEC and other producers to limit their production to meet our peg price, giving some added incentive to get the price up to our peg price. What do you think about that?

Mr. Damron. A floor price still gives you an oil import fee if the world oil price is below the floor price. So that still means that the chemical industry is less competitive in world markets under that circumstance.

Mr. McCrery. That is true. If the world price were below the peg price and we had an import fee, you are right; it would increase your cost vis-a-vis your competitors. But if that peg price gave the rest of the world's producers the incentive to cut production to meet our peg price, then you wouldn't be at a disadvantage.

Ms. LAZENBY. My comment is that the independent producers would welcome such an initiative. But I understand the concerns that the chemical industry and I am sure the refining industry might have. I would like to say that as independent producers and U.S. independent producers and business people we, like the refiners and the chemical people, are paying a very high environmental cost which we are happy to pay.

We are responsible operators, and we would like to work together with this committee and our sister industries to try to come up with some method that keeps our refining, our chemical and our production business alive. We may have differences in nuances, but we ought to be able to sit down and work something out and do it now because the time is fleeting.

Mr. CAMPBELL. If I could make one point. I indicated to you that the laws are increasing the cost in this country so there is no need to exacerbate that. We are not in a equilibrium state. We have just begun to make the investments as far as the Clean Air Act and other regulations are concerned, so it is not a state of equilibrium.

An important point is that rather than make these investments, in many cases, we are shutting down plants. I just shut down the fuel section of our Tulsa refinery. We laid off the people in that refinery that has been around for almost 100 years; because you can't invest $150 million in that refinery. As we continue to move forward with reformulated gasoline one in 1995, reformulated two in 1998, there will be more and more of those plants shut down.

As long as you can take the industry and go offshore and produce the product and pollute there and bring it back in under today's costs in this country, you have to recognize that you are going to shut down the refining industry in this country. I do consider that a national security issue, and I will tell you the reason why. When we are talking about importing crude oil, you are talking probably between 12 and 15 countries out there and the threat has always been the formation of a cartel and consequently their dictating prices to you.

In the case of product, you have very few foreign manufacturers overseas. You don't have 12 to 15. Consequently, once we shut down refineries, there is no starting them back up again. If you export that business, you will become dependent upon relatively few foreign manufacturers to put that product into this country.

By the way, if you recall, I was only talking about gasoline and blending components, not distillate and heating oils, and petrochemicals and residuals, et cetera. You primarily hear about gasoline and gasoline blending components only. You say don't exacerbate the problem. But as each year goes forward, it will get much worse.

Mr. MCCRERY. I was referring to other manufacturing sectors of the economy, not yours.

Mr. Damron.

Mr. DAMRON. Congressman, let me make a few comments here. We are in support of the refining industry. We are dependent on the refining industry, so we would like to see the domestic refining industry do well because they supply our raw materials.

Two, the concern about environmental regulation they have also applies to other people that have to comply with environmental regulations also and compete with foreign competitors that do not have to comply with those same type of regulations.

Three, if you want a differential between the crude price and the refined petroleum products, the only way I can see you can maintain the differential is put some kind of a ceiling on crude oil. We are not proposing a ceiling, but it seems that would be necessary in order to maintain a differential.

Mr. McCRERY. Thank you very much.

Thank you, Mr. Chairman for your indulgence. This country faces a problem with respect to its energy needs and its domestic energy producing and manufacturing sectors, and it is something this committee ought to be concerned about.

Thank you all for your testimony.

Mr. PAYNE. Mr. Camp.

Mr. CAMP. Thank you, Mr. Chairman. I will direct my questions to Mr. Alfers or Mr. Kelly, whoever can answer them.

Regarding the severance tax on hard rock minerals, what would that include and can you tell me what "hard rock minerals" means?

Mr. KELLY. Let me say that I was very surprised when the announcement came out about the proposal for the severance tax and the first persons that I called, because I didn't think there was a Tax Code definition, was our geologist and R&D people, and they weren't sure, and had a, apparently a glossary of terms used in the mining industry, and the response was that any mineral that has to be blasted as a part of its mining extraction process is a hard rock mineral, and consequently iron ore is about as hard a rock substance as you can get.

And it was at that point that I concluded that we had to take this matter seriously. In trying to find out more about the genesis of this proposal, we ran into, you might say, a blind alley. We could not trace it back, and even today, we were attempting to try to find out if iron ore was, let's say, originally intended to be part of this severance tax, and we have not been able to get a conclusive answer as of this moment.

Mr. CAMP. Mr. Chairman, do we have before the committee any revenue estimates for this particular proposal, any background on how this information or calculation might be made?

Mr. PAYNE. We do not have any such revenue estimate.

Mr. CAMP. Do we know if there are any studies that have been submitted to the committee on this proposal?

Mr. PAYNE. Not at this time.

Mr. CAMP. Thank you very much. Just as an aside, Mr. Campbell, your company used to have a regional headquarters in my hometown and it was a very welcome corporate citizen. I think one of the reasons it is not there anymore is outlined in your testimony. It was good to have you here and I appreciate your comments.

Mr. CAMPBELL. Thank you very much.

Mr. PAYNE. I have a couple of questions just to further my understanding concerning, first, the import fee. Ms. Lazenby, you said that right now you are losing $2 a barrel at the world price so that means there are people in the world who are able to produce oil for $2 a barrel less than our domestic manufacturers or domestic producers are producing oil and are still, I assume, making a profit?

Ms. LAZENBY. That is correct.

Mr. PAYNE. In order to sell at today's world price?

Ms. LAZENBY. That is correct.

Mr. PAYNE. Then the increased tariff being discussed here is 15 cents per barrel?

Ms. LAZENBY. No, 85 cents per barrel.

Mr. PAYNE. So that, at least in today's market, it doesn't equate to the differential——

Ms. LAZENBY. It doesn't completely cover our problem, but what it is is an offset for some tax policies, the tax policy where we could get a production credit, where we could raise additional funds in order to keep our production going.

For example, if you have production and it is a declining asset and production is going down, if you can take some cash flow that you could get from reduced taxes. Right now we are not paying a lot of tax because we are losing money, we don't have a positive cash flow. The reason for this proposed import fee, there are two reasons. One is to pay for the proposed production credit that Representative Mike Andrews proposed, which would give cash flow to producers in order to be able to reinvest that and keep the production from falling.

The other rationale and necessity for something, and it has come up now because of the steep drop in prices and it doesn't look like it is going to turn around soon, is the very low price that makes just our base production uneconomic. So there are two problems.

One is keeping base production alive with a price that is a floor price that keeps us at least at a positive cash flow or else you are looking at losing a million barrels a day. Yes, there are countries and companies that can produce oil at lesser price but the question is are we going to let that cheaper oil come in and lose 100,000 jobs and increase our trade deficit by $7 billion? That is the ultimate question.

Mr. PAYNE. What would an import tax of 85 cents a barrel on crude oil ultimately cost the consumer per gallon of gasoline?

Ms. LAZENBY. Less than 2 cents.

Mr. PAYNE. Mr. Campbell, won't there be problems associated with an import fee relative to our GATT agreement?

Mr. CAMPBELL. Mr. Chairman, the short answer to that is no. Both U.S. trade laws and the GATT agreement recognize the need for unilateral tariffs in the event that a country such as the United States has a national security issue. I think there have been a number of studies, the most recent completed in July of this year, indicating the trend we are on in the national refining industry is creating a national security issue.

That is at least part of an answer to my colleague who indicated that—the issue I am talking about applies to U.S. manufacturing in general to the degree that products can be produced overseas at less cost and consequently you shut it down here. The difference between our industry and the rest of manufacturing is the issue around national security, so it does not conflict with the GATT agreement.

Mr. PAYNE. I have also one question concerning mineral resources, and Mr. Alfers, you mentioned as you began your testimony that you weren't sure whether this is private land or public land and I am not sure either. I understand that there are a million-plus hard rock mining claims now on Federal lands based on the mining laws of 1872, and my question to you is: Do you feel that it would be appropriate on Federal lands for those who extract hard rock minerals to pay something in terms of a royalty or severance tax back to the taxpayers as those minerals are extracted?

Mr. ALFERS. This issue of a fair return to the public has been aired now since 1989, and the industry has come to supporting a bill that has passed the Senate that includes both holding fees and a royalty. Those holding fees have been introduced as part of the budget process for the past couple of years and have had quite an impact. Just as of September 1993, we are now able to see how the small business operators in the mining industry have so quickly responded to just this $100 holding fee.

Many thought it would be very small and very little impact, and there were those who would argue that taxes on an industry like this can simply be passed on somewhere. We have learned in the past couple of weeks that claims are dropping. We don't know exactly how much. A newspaper on the West Coast reported, estimated between 60 and 80 percent of the holdings of these mining claims will be dropped.

That is important for all of us trying to project revenue impacts and economic impacts, because a $100 fee on a claim that is dropped yields $0, not $100. So it underscores the point that when we impose a tax on mining on these public lands, whether it is a holding fee or a royalty, we are dealing with an industry that cannot pass on these burdens. They deal in a highly competitive market especially in the case of metals. The response will be to drop their land holdings, close or downsize mines or cut their exploration projects and send them elsewhere. We are seeing evidence of that now.

Mr. PAYNE. I think you mentioned that the average margin was 8 or 9 percent. Is there a differential between the private land and public lands profit differential?

Mr. ALFERS. I have not seen one that has shown up in our data. We didn't specifically look project by project to test profit margins. The profit margins tended to be more of a variance of the life of the mine, the commodity and the current prices and not a fact that they are on public lands or private lands.

Mr. PAYNE. But wouldn't it be true that the cost of goods would be higher on private lands where more payments would have to be made than on public lands?

Mr. ALFERS. In some cases that may be so, where there may be a greater burden of, say, private royalties. The fact is that a mining project whether a public lands project or private lands project stands many royalties because in the mining business, the royalty is really compensation for those along the chain of title in a project that have made contributions and led to the discovery of the deposit.

That is so on private lands and public lands. So a prospector on public land who discovers a project and turns that project to a major mining company will have a royalty very much like a private royalty. So it is not fair to see this as an unlevel playing field.

On the private side, those who contribute to the discovery of a project are often rewarded for that, and that is also so for those prospectors and explorers on public lands. I wouldn't expect to see a big differential there.

It is also fair to say that a high tax in the area of, say, 12 percent on the gross or high royalties would no doubt disadvantage public lands, because that sort of burden is not common in the private sector. Ordinarily, one does not have to negotiate for 140 percent of the margins to obtain a project in the private sector. So these royalties and these taxes would tend to drive projects somewhere else, overseas, private lands if we have them.

In this country, private lands is no refuge for the mining industry. Public lands occupy nearly a third of the land area of the United States and in the areas where the minerals occur, it is a much higher percentage than that—90 percent in some western states, 95 percent in Alaska. These are all public lands, and if we effectively deny access to these public lands, there is no place for that industry to go. There is not enough private land with minerals on them in order to fill that gap. We are seeing now the exploration dollars going overseas and that is likely where it will go.

Mr. PAYNE. You said that your industry was supporting the actions of the Senate. What did the industry decide to support?

Mr. ALFERS. The industry supports Senator Craig's bill which has passed the Senate. It is a bill that has among other things a holding fee on the holding of mining claims, a production royalty on the production of minerals off of mining claims, an abandoned mine land fund, some reform of the reclamation bonding, some provisions to assure compliance and reclamation of all permitted mines on public lands. But the main distinction between the approaches in the Senate and the approaches in the House are really in this royalty.

On the Senate side, it is a royalty that is based on the net profits from the mining. It is not exactly a net profit as some may know it, but it is net of mining costs and then downstream processing cost.

On the Senate side, we have a royalty based on the gross proceeds received from the sale of a finished product. There is something unfair about that gross proceeds approach. A gross proceeds approach has no analog anywhere that I know of. It is not like Federal royalties on coal; it is not like Federal royalties on gas. Those royalties are paid at the well head in the case of oil and gas, and they are paid at mine mouth in the case of coal.

The royalty in the House bill is on a finished product of, say, gold. It is not like those other products. In the case of metals mining, which we spent some effort to analyze these, there was a lot of value added from the mouth of the mine to market. That is the problem. That is why we see this arithmetic that says an 8 percent royalty can swallow 80, 85 percent of the profit margin.

The Senate bill measures the royalty at the mine mouth. That means profitable mines pay the royalty, less profitable mines carry a lesser burden, but they are allowed to stay open. We save the jobs and we continue the life of the mines somewhat longer and they can that way fund the reclamation that is already required in the permits.

Mr. PAYNE. Thank you.

Mr. Hoagland.

Mr. HOAGLAND. Mr. Alfers, have you had a chance to review the testimony that will be presented in the next panel by Friends of the Earth?

Mr. ALFERS. I haven't seen it. Before I walked up here, I just saw a couple of pages of that.

Mr. HOAGLAND. Maybe you are unable to respond then to some of the statements in the second section of their testimony, impose a severance tax on hard rock minerals. I will read the initial paragraph.

"Hard rock mining has come under increasing scrutiny for its legacy in environmental and social damage. The Mineral Policy Center recently documented the vast environmental damage caused by more than a half million abandoned hard rock mines in its report, "Burden of Guilt." Left behind after mining companies pull out of mines are wastes containing highly toxic substances such as arsenic, asbestos, cyanide and mercury. These wastes contaminate nearby air, land, water and underground aquifers." And then it continues to study data collected by the World Resources Institute. And their concern sounds like the huge piles of tailings that are left behind untended. And that it would—to clean up and restore areas surrounding mines requires billions of dollars, between $32 and $71 billion they estimate here.

Mr. ALFERS. I will try to respond to that. I haven't had a chance to review it carefully. First, it is important to draw a distinction between the reclamation of mines from the past and the reclamation of mines now. I thought I heard you using the present tense there.

Mines permitted today require reclamation, so it is a mistake to try to impose too harsh a burden on those who are doing the environmental job to pay for something in the past. Mining companies reclaim today. Did they always reclaim? No; no more than manufacturers or anybody else who operated before the word environmental even found its way into our lexicon.

We have a problem here with abandoned mines from the past and there are lots of solutions. I rather think that the numbers that we see from the Mineral Policy Center are a little overblown. But whether they are or not, what is important is not to get the cart before the horse.

We should figure out what the problem is and how to solve it before we try to fund it. A number of ways to solve these abandoned mine problems is to encourage the remining of these projects, for example. If they are remined and permitted, they will be reclaimed, and we are seeing examples of that now around the West. So I think we should all take a look at this problem.

The Senate bill which industry supports provides for an mind land reclamation fund, an abandoned mine fund, and we would like to see this problem solved, but we should get our arms around the magnitude of it before we try to fund it.

Mr. KELLY. Could I have a quick response from an iron ore perspective? I would say that the lady that you are referring to from what you have read has to be exaggerating. It sounds like there is a Love Canal in every county in the United States, and I think this has to be an exaggeration.

I also want to say that iron ore happens to be, and that is what I represent here, an inert waste problem, and is not of any consequence whatsoever. I agree with Mr. Alfers on the reclamation requirements, but I would also and moreover say that we have a Superfund law and we have state laws such as in Michigan—it is the 307 sites—and these are mines that have previously been closed.

And there is a tremendous effort being done to find the responsible parties, and through the Superfund law, they are being cleaned up, we think not at quite the rate they should be, but I think that is a deficiency in the Superfund law, which is of course not our subject here today.

Ms. LAZENBY. May I make one more comment? I would like to say that I understand the administration is considering a floor price, which would take care of or help alleviate this up and down ride on crude prices and that the small import fee would be in combination with a floor price and the small import fee would be used to offset the tax policy such as Congressman Andrews proposes to stimulate domestic production. We need a combination, but we need something to keep the bottom from falling out from underneath us.

Mr. PAYNE. Thank you. I thank the panel. It has been interesting for the subcommittee. We appreciate your time, especially waiting while we went to vote.

Thank you.

Mr. HOAGLAND. Good afternoon, everyone. We now have before us panel 6, and the first witness that we are to hear from is Dawn Erlandson from Friends of the Earth. Ms. Erlandson.

STATEMENT OF DAWN ERLANDSON, DIRECTOR OF TAX POLICY, FRIENDS OF THE EARTH

Ms. ERLANDSON. Thank you. Mr. Chairman and members of the committee, good afternoon. I am Dawn Erlandson, director of tax policy for Friends of the Earth. Friends of the Earth is a global environmental advocacy group with affiliates in 50 other countries. Thank you for the opportunity to appear before the committee today on behalf of Friends of the Earth to express our support for three of the miscellaneous revenue proposals before you.

They include expansion of the tax on ozone depleting chemicals, a severance tax on hard rock minerals, and disallowance of deductions for environmental malfeasance. These proposals represent opportunities not only to raise revenues for the Federal Treasury, but also to further environmental protection. The tax on ozone depleting chemicals is one of the most powerful tools that Congress has created to protect the ozone layer. Unfortunately all chemicals that deplete the ozone layer are not taxed.

Accordingly, we urge the committee to cover those chemicals. They include methyl bromide, hydrochlorofluorocarbons or HCFCs, and hydrobromofluorocarbons or HBFCs. Methyl bromide is a widely used fumigant pesticide that not only depletes the ozone layer, but is extremely toxic. Methyl bromide is currently responsible for 5 to 10 percent of ozone depletion and if emissions continue to increase, it will be responsible for 15 percent of ozone depletion by 2000.

Industry is marketing HCFCs as bridge chemicals between CFCs and ozone safe alternatives, yet some HCFCs are as damaging as methyl chloroform, which is already taxed. Further scientific research conducted by NOAA shows that HCFCs are more damaging to the ozone layer than previously thought. Industry is developing HBFCs to replace firefighting chemicals known as halons, yet ozone safe alternatives to halons exist.

It is important to note that Congress has previously taxed all chemicals controlled by the Montreal protocol. In addition, all chemicals categorized as class one substances under the Clean Air Act are taxed. Since the committee last amended this tax, the parties to the Montreal protocol met in November 1992 in Copenhagen and listed all three chemicals as controlled substances.

In addition, they proposed phasing out HBFCs by 1996, freezing consumption of methyl bromide at 1991 levels in 1995, and requiring industrialized countries to cap HCFC use in 1996 and phase it out by 2030. In February EPA proposed listing methyl bromide and HBFCs as class one substances under the Clean Air Act and accelerating the HCFC phase out schedule. They also proposed freezing production of methyl bromide at 1991 levels by 1994 and phasing it out by 2000, as well as phasing HBFCs out by 1996.

More than a half million abandoned hard rock mines have contaminated the air, land and water of nearby communities. Hard rock mining produces massive quantities of waste and a trail of toxics, including arsenic, cyanide, asbestos and mercury. Given the legacy of environmental degradation associated with hard rock mining, we urge the committee to adopt a broad-based severance tax on hard rock minerals as both a means to compensate taxpayers in affected communities for the value of the resource extracted and for the waste and pollution left behind, as well as a funding mechanism for cleanup and reclamation.

Estimates of the costs of reclamation range from $20 to $70 billion. Of course, any severance tax adopted should complement current efforts to reform the 1872 mining law. Yet as the focus of mining reform law is on public lands, 85 percent of hard rock mining occurs on non-Federal lands. Clearly then a broad severance on all extraction rather than on extraction from Federal lands only would raise the most revenue.

Finally, when the Exxon Valdez ran aground off the coast of Alaska, we were horrified at the devastation that resulted. Somewhat relieved, we learned that Exxon would have to pay over $1 billion to the Government for the disaster. What few of us know is that that $1 billion was tax deductible and that Exxon was able to reduce its tax bill and therefore shift $250 million or one-fourth of the settlement cost to America's other taxpayers. Outrageous but perfectly legal.

Under current law, companies that pollute the environment, whether by illegally dumping toxic wastes or spilling oil, can deduct the associated costs as ordinary and necessary business expenses. What are not ordinary and necessary business expenses under current law include illegal bribes and kickbacks, net gambling losses and lavish meal or beverage expenses. Even this committee and this Congress have found it appropriate to limit the deductibility of certain business expenses associated with behavior that is clearly less deplorable than many environmental crimes. Indeed, the budget bill just adopted eliminated business deductions for lobbying and for executive pay over $1 million.

The code then denies business deductions for normative reasons in order to engender policies of less than critical concern, yet there are no such limitations on illegal environmental pollution and degradation. It is time that the Federal tax law reflect the fact that polluting this Nation is not an ordinary and necessary business expense. We urge you to adopt legislation proposed by Congressman Gerry Studds, H.R. 2441, and eliminate the ability of companies that pollute the environment to pass on their costs to other taxpayers. Thank you.

Mr. HOAGLAND. Thank you, Ms. Erlandson.

[The prepared statement follows:]

FRIENDS
earth
218 D Street SE • Washington DC 20003

Statement of

Dawn Erlandson
Director of Tax Policy
Friends of the Earth

On Behalf of

Friends of the Earth

Regarding

Miscellaneous Revenue-raising Proposals

Before the

Subcommittee on Select Revenue Measures
Committee on Ways and Means
United States House of Representatives

September 8, 1993

INTRODUCTION

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, I am Dawn Erlandson, Director of Tax Policy for Friends of the Earth (FoE). Friends of the Earth is a global environmental advocacy organization with affiliates in 50 other countries.

Mr. Chairman, I thank you for the opportunity to appear before the Committee on behalf of Friends of the Earth to express our strong support for three of the miscellaneous revenue proposals before you today. These proposals represent opportunities not only to raise revenues for the Federal Treasury but also to further environmental protection. We urge the Committee to embrace these environmentally sound tax proposals as it has similar proposals in the past.

STRENGTHEN THE TAX ON OZONE-DEPLETING CHEMICALS

The tax on ozone-depleting chemicals is one of the most powerful tools Congress has created to protect the ozone layer. This economic instrument has successfully encouraged industry to adopt alternatives to CFCs and increase CFC recycling. In the short period since the tax took effect in 1990, U.S. CFC production has dropped significantly, well below the limit allowed by the Montreal Protocol, the international ozone protection agreement.

Unfortunately, all chemicals that deplete the ozone layer are not taxed. Accordingly, we urge the Committee to extend the current tax on ozone-depleting chemicals to three additional kinds of chemicals that harm the ozone layer and threaten human and ecological health. These chemicals are methyl bromide, hydrochlorofluorocarbons or HCFCs, and hydrobromofluorocarbons or HBFCs.

We propose that the Committee tax these chemicals using the same approach that exists under current law: the tax equals the base tax rate multiplied by each chemical's ozone depletion potential (ODP). The base rates established by the Energy Policy Act of 1992 should be used. These rates per pound are: $4.35 in 1994, $5.35 in 1995, $5.80 in 1996, $6.25 in 1997, and $6.70 in 1998.

1. Tax Methyl Bromide

Methyl bromide is a widely used fumigant pesticide. It not only depletes the ozone layer but is extremely toxic and can be lethal if mishandled. The bromine in methyl bromide is a very effective ozone depleter. According to the United Nations Environment Program's (UNEP) Methyl Bromide Interim Scientific Assessment of June 1992, methyl bromide is currently responsible for five to ten percent of ozone depletion, and if emissions continue to increase at current rates, it will be responsible for fifteen percent of ozone depletion by 2000.

The Parties to the Montreal Protocol listed methyl bromide as a controlled substance in Annex E of the November 1992 Copenhagen amendment to the protocol. The amendment freezes industrialized country consumption of methyl bromide at 1991 levels in 1995. The Parties resolved to decide on further controls and a possible phaseout date by no later than their seventh meeting in 1995.

On February 16, 1993, the U.S. Environmental Protection Agency announced a proposal to list methyl bromide as a Class I Substance under Title VI of the Clean Air Act Amendments of 1990. The Notice of Proposed Rulemaking proposes to freeze methyl bromide production at 1991 levels by January 1, 1994 and phase out production by January 1, 2000.

Congress has previously taxed all chemicals controlled by the Montreal Protocol. The tax initially covered CFCs and halons, and subsequently Congress expanded the tax to include methyl chloroform and carbon tetrachloride. The expansion followed the June 1990 London amendment to the protocol, which added these chemicals to the list of controlled substances. In addition, all chemicals categorized as a Class I Substance under the Clean Air Act are subject to the excise tax.

Annex E of the Copenhagen amendment to the Montreal Protocol lists methyl bromide's ozone depletion potential (ODP) at 0.7. Based on an estimated 1991 methyl bromide production level of 50 million pounds per year, a methyl bromide tax would yield $995.75 million over the 1994-1998 period. This revenue estimate, however, does not account for conservation measures which the tax would initiate or a more stringent phaseout schedule.

UNEP's June 1992 methyl bromide assessment indicates that significant reductions in methyl bromide can be achieved during the 1990s by replacing the chemical with alternatives, using recovery and recycling technology, and adopting improved practices.

EPA's policies aimed at methyl bromide will not cut methyl bromide consumption below 1991 levels until 2000. Worsening ozone depletion requires much stronger measures. Increasing the price of methyl bromide with a tax will create an incentive for industry to immediately reduce consumption.

2. Tax HCFCs

Industry is marketing HCFCs as "bridge" chemicals between CFCs and ozone-friendly alternatives. Nonetheless, HCFCs are ozone-destroying chemicals and should not be exempt from the tax. Indeed, some HCFCs are as damaging as methyl chloroform, which is taxed. (According to the ODPs listed in the Montreal Protocol and the Clean Air Act, HCFC-141B and methyl chloroform have the same ODP of 0.1.)

Congress recognized the environmental impact of HCFCs in the Clean Air Act Amendments of 1990. The Act requires HCFC recycling, bans certain HCFC applications, and phases out HCFC production between 2015 and 2030.

Parties to the Montreal Protocol listed HCFCs as controlled substances in the Annex C of the November 1992 Copenhagen Amendment to the protocol. The Amendment requires industrialized countries to cap HCFC use in 1996 and then reduce HCFC consumption by 35% in 2004, 65% in 2010, 90% in 2015, 99.5% in 2020, and 100% in 2030.

On February 16, 1993, the U.S. EPA announced a Notice of Proposed Rulemaking that proposes accelerating the HCFC phaseout schedules in the Clean Air Act on the basis that such reductions are necessary to protect human health and the environment and that they are technically feasible. The agency is proposing to phaseout HCFC-141B in 2003, HCFC-22 and HCFC-142B in 2020, and all other HCFCs in 2030. The agency believes these reduction will meet the HCFC requirement of the Copenhagen amendment to the Montreal Protocol.

Scientific research conducted at the US National Oceanic and Atmospheric Administration (NOAA) shows that HCFCs are more damaging to the ozone layer than previously thought. While their long-term ozone-depleting potentials (ODPs) range from 2 to 10 percent of that of CFCs, their near-term (5 to 10 years) ODPs are much higher. For example, HCFC-22 has an ODP of 0.19 over 5 years and 0.17 over 10 years while its steady-state ODP is only 0.05.

Ozone-safe, chemical-free alternatives and less harmful chemicals to the ozone layer, such as HFCs, have been developed. While HCFCs and HFCs tend to contribute to climate change, HFCs tend to be more expensive than HCFCs. Taxing HCFCs would encourage industry to adopt the most environmentally sound alternatives.

Based on estimates of ODP-weighted HCFC production in the United States, an HCFC tax would yield $753.02 million over the 1994-1998 period.

3. Tax HBFCs

HBFCs are chemicals that industry is developing to replace fire-fighting chemicals known as halons. HBFCs have higher ODPs than HCFCs. For example, Fire Master 100 (HBFC-22B1), developed by Great Lakes Chemical to replace Halon-1301 and Halon-1211, has an ODP of 0.7.)

Industry has developed ozone-safe alternatives to halons. For example, Ansul Fire Protection is manufacturing a halon replacement called Inergen, which has an ODP of 0.

Parties to the Montreal Protocol listed HBFCs as controlled substances in Annex C of the Copenhagen Amendment. Due to their high ODPs, the Parties agreed to phase out HBFCs by January 1, 1996, on the same schedule as CFCs.

EPA's Notice of Proposed Rulemaking proposes listing HBFCs as Class I Substances and phasing them out by January 1, 1996.

IMPOSE A SEVERANCE TAX ON HARD ROCK MINERALS

Hardrock mining has come under increasing scrutiny for its legacy of environmental and social damage. The Mineral Policy Center recently documented the vast environmental damage caused by more than half a million abandoned hardrock mines in its report, *Burden of Guilt*. Left behind after mining companies pull out of mines are wastes containing highly toxic substances such as arsenic, asbestos, cadmium, cyanide, and mercury. These wastes contaminate nearby air, land, water and underground aquifers, thus threatening human health as well as the economic vitality of neighboring communities.

In addition to a trail of toxics, mining operations leave behind massive quantities of waste. According to unpublished data from the World Resources Institute, much of the excavated material from mining operations is waste. For both metals and non-metallic minerals, overburden waste accounts for 29 percent of the total metric tons of material mined. For metals such as phosphorus and copper, overburden wastes account for 57 percent of the total material mined. And in the case of gold, overburden waste accounts for a whopping 78 percent of the total material excavated.

Given the legacy of environmental degradation associated with hardrock mining, we urge the Committee to consider adoption of a broad-based severance tax on hardrock minerals as both a means to compensate taxpayers and affected communities for the value of the resource extracted and for the waste and pollution left behind and a funding mechanism for cleanup and restoration. Such a tax would be levied as hardrock minerals are removed, or "severed," from the mine. The rate of tax as proposed would be 12 percent of the value of the removal price of the mineral.

To clean up and restore areas surrounding mines requires billions of dollars. The Mineral Policy Center estimates that cleanup costs range from $32.7 to $71.5 billion. A severance tax such as the one under consideration by the Committee could provide essential resources to undertake the desperately needed cleanup. Precedence for such a dedicated fund exists in the form of the Abandoned Mine Land Fund for restoring abandoned coal mines. Such a fund could be financed with a reclamation fee or a severance tax.

As you know, the Committee on Natural Resources is in the process of reforming the Mining Law of 1872 and is examining the issue of royalties. The environmental community strongly supports reform and has endorsed reform legislation, H.R. 322. We urge the Ways and Means Committee to work closely with the Committee on Natural Resources to adopt a suitable reform plan that includes severance taxes.

Much of the focus of reform of the 1872 Mining Law is on the management of hardrock mining operations on public lands. However, environmental damage caused by hardrock mining does not occur only on federal lands. In fact, an estimated 85 percent of hardrock mining actually occurs on non-federal lands. These lands include private, state-owned and federal lands that have been "patented" by private companies for mining.

Clearly, the greatest revenue to be raised would come from a broad-based severance tax on all extraction rather than on extraction from federal lands only. An ancillary benefit of a broad severance tax would allow the federal government to collect some financial remuneration from companies that have taken title to public land through patents. Under current law, patenting precludes the federal government from collecting royalties from the mining companies. Historically, mining companies have patented lands when they feared the imposition of royalties on the minerals removed. Recently, the Bureau of Land Management has been deluged with patent applications by miners seeking to avoid paying the royalties which seem imminent in the proposed reform of the 1872 Mining Law.

Many states have some form of severance tax on hardrock mining. Generally, these severance taxes apply to all mining, not just that on state-owned lands. Since many states already impose severance taxes, it would be relatively simple to follow with a federal severance tax. Further, the existence of both state and federal levies on cigarettes and gasoline demonstrate that the existence of a tax at one level does not preclude the existence of a similar tax at another level.

As it is clear that taxpayers have an interest in assuring that public lands not be ravaged by profit-seeking mining operators and that they be duly compensated for the value of the mineral as well as cleanup costs and environmental restoration associated with the mining wastes, we submit that a federally-imposed severance tax be adopted in order to further the public interest.

DISALLOW DEDUCTIONS FOR ENVIRONMENTAL MALFEASANCE

In 1989, the Exxon Valdez ran aground off the coast of Alaska and spilled nearly 11 million gallons of crude oil into Prince William Sound. In 1991, Exxon reached a settlement with the Federal Government and the State of Alaska in which it agreed to pay $1.025 billion in fines and damages to repair the vast environmental destruction to the Alaskan shoreline. Of the $1.025 billion, only $25 million was an actual fine and, under current law, not tax deductible. The remainder of the settlement, however, was characterized as restitution and therefore was and is tax deductible. Indeed, $1 billion in clean-up costs, legal fees, damages, and even the 11 million gallons of oil that devastated the Sound were tax deductible.

The effect of the ability of Exxon to deduct these costs from its tax bill were dramatic. According to analyses done by the National Wildlife Federation and the Alaska State Legislature, the value of the $1 billion in federal and state tax deductions to Exxon ranged from $279 to 298 million dollars in reduced tax liability. The National Wildlife Federation estimated that Exxon would reduce its federal tax bill by $257 million and its Alaskan tax bill by $22 million.[1] As a result, Exxon successfully shifted part of its responsibility for the devastation it wrought in Alaska to America's taxpayers, some of whom lived in Alaska and suffered direct damage from the spill.

Last Congress, Congressman Frank Guarini recognized the outrageousness of requiring American taxpayers to assume even part of the responsibility for a company's negligent, even intentional, pollution of the environment. He introduced legislation, H.R. 1726, to limit tax deductions in cases of environmental malfeasance.

This Congress, Chairman Gerry Studds has offered comparable legislation, H.R. 2441. Chairman Studds bill would disallow deductions for amounts paid pursuant to settlements and for compensatory damages under certain environmental laws. The money saved by eliminating this tax break would be used as an offset for tax relief for people who pay a disproportionately high percentage of their income for sewer and water services. We urge the Committee to adopt Chairman Studds legislation and limit the ability of companies that pollute the environment to pass on their costs to other taxpayers.

Under current tax law, companies that pollute the environment, whether by spilling oil or dumping toxic wastes illegally, are allowed to deduct all the costs associated with the pollution as ordinary and necessary business expenses, even though the companies were found to have broken the law.

Some would argue that these costs should continue to be deductible because the purpose of the Code is to raise revenues and that businesses, whether good or evil, are taxed on their net incomes. Since ill-gotten gains are taxed, some argue, then the costs of producing such gains should be deductible. However, under U.S. tax law, all tax deductions were once subject to the so-called "public policy limitation," the thrust of which was to disallow a deduction in any instance where allowing the deduction would frustrate a sharply defined government policy. This "public policy limitation" remains in effect for a few business deductions that are deemed to violate the public good including illegal bribes and kickbacks, treble damage payments under the antitrust laws, and fines and penalties.[2]

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[1] Hearing Record, Task Force on Urgent Fiscal Issues, Committee on the Budget, U.S. House of Representatives, "Budgetary Implications of the Exxon Valdez Oil Spill Settlement," October 31, 1991, Washington, DC.

[2] Asbjorn Eriksson, Robert Hertzog, John Tiley, David Williams, Friedrich von Zezschwitz, Taxation for Environmental Protection: A Multinational Legal Study, ed. Sanford E. Gaines and Richard A. Westin (Westport, CT: Quorum Books, 1991), pp. 187 - 189.

Even this Committee and this Congress have found it appropriate to limit the deductibility of certain business expenses associated with behavior that is clearly less deplorable than oil spills or dumping of toxic wastes. Indeed, the budget bill that the Congress just passed eliminated the business deductions for lobbying expenses and executive pay over $1 million. It further limited the deduction for business meals and entertainment expenses to 50 percent, thereby complementing current law which denies all deductions for meal or beverage expenses that are lavish or extravagant.

The Code, then, denies business deductions for normative reasons in order to engender policies of less than critical concern, yet there are no such limitations on producers of environmental pollution and waste. No justifiable reason can explain why we deny business deductions for high executive pay and lobbying expenses while allowing deductions for expenses related to illegal environmental devastation. Failing to bar taxpayers from claiming deductions for environmentally destructive business behavior amounts to a tax subsidy for *prima facie* illegitimate behavior.[3]

The Studds bill sends the right messages to corporate polluters. Continuing to allow income tax deductions for violations of environmental laws seriously undermines the deterrent effect of the environmental laws. In many cases, it may be cheaper for a company to risk a violation than to invest in prevention. Thus, denying deductions for environmental cleanup expenses would provide a significant incentive for companies to comply with this nation's environmental laws, and to safeguard against negligence. Contrary to industry arguments, denying deductions would not frustrate expenditures for environmental cleanup because, under law, the companies must clean up. There is no need to provide incentives to obey the law. It is time the federal tax code reflected the fact that polluting this nation is not an ordinary and necessary business expense.

This Committee has heard in the past about the perverse effects of current U.S. tax policy on the environment. Allowing a tax deduction for cleanups associated with environmental crimes, at a time when honest taxpayers cannot afford adequate water and sewage service, is the quintessential example of this perversity. Currently, we give tax breaks to polluters, while communities cannot pay their sewer and water bills because of the high costs of dealing with water pollution. The Studds bill addresses this incongruity. Polluters must pay for the harms that they cause, only then will they recognize the true costs of their actions. The American taxpayer must no longer subsidize behavior that is environmentally irresponsible.

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[3] Ibid.

Mr. HOAGLAND. Mr. Merlis.

STATEMENT OF EDWARD A. MERLIS, SENIOR VICE PRESIDENT, EXTERNAL AFFAIRS, AIR TRANSPORT ASSOCIATION OF AMERICA

Mr. MERLIS. Thank you, Mr. Chairman. I appreciate the opportunity to appear before you today to discuss several revenue measures which will have a substantial impact upon the financial health of the U.S. air carriers. I am Edward Merlis, senior vice president of the Air Transport Association of America. ATA's 17-member carriers fly 96 percent of the revenue passenger miles and 97 percent of the freight carried by U.S. flag carriers.

The airline industry is currently facing desperate financial times. Having suffered unprecedented losses since 1990, airlines have parked aircraft, slashed capital orders and furloughed workers.

As a result, earlier this year the Congress established a National Airline Commission to investigate, study, and make policy recommendations about the financial health and future competitiveness of the U.S. airlines and aerospace industry. The commission has now completed its report and documented industrywide losses of $10 billion over the last 3 years.

Among the negative influences on airline industry health cited by the commission were, "tax policies which often have had a major and adverse effect on the industry." Although the commission concluded that "tax changes alone will not restore the industry to profitability," it did observe without hesitation that "we believe there are several tax provisions that impede the ability of the industry to return to financial health." Thus, it is with some chagrin that the industry finds itself once again in the position of needing to address proposed changes to the Tax Code which would adversely affect the environment in which we operate, particularly in light of the commission having identified Federal taxes totaling more than $1.5 billion per year that need to be cut. Measures which in the commission's words "violate reasonable principles of common sense and good public policy."

Instead of appearing here today in support of efforts by Congress to implement the recommendations of your commission, we are here discussing a series of proposals which would exacerbate the financial strains on the industry and add to the tally of jobs lost in the airlines, aircraft, and engine manufacturers and in the travel and tourism industry.

The first proposal I would like to address amends the Internal Revenue Code to deny a business deduction for that portion of the cost of an airline ticket in excess of coach fare. While the proposal will be directed at the business traveler, the true burden will fall upon the airline industry itself. To the extent flyers switch to coach as a result of the enactment of this proposal, the Government does not gain any revenue and the airline industry loses much needed revenue. Assuming all business travelers, who would otherwise travel in business or first class switched to coach class for domestic tickets only, the U.S. airline industry would lose $220 million per year and would in all likelihood lay off several thousand flight attendants.

In actual practice we do not expect all, nor do we know which business travelers who currently travel in business or first class would switch to a coach seat. Some may, in fact, choose to charter aircraft at greater cost to the Treasury and greater injury to the airlines.

This proposal is particularly objectionable to ATA member airlines because it arbitrarily singles out, one, travel from other business expenses and, two, air travel from other business travel. The proposal clearly and unfairly targets the airline industry. Deductions for business expenses for other sectors of the travel industry, such as hotels, cruise lines, trains and rental cars, are not impacted by this proposal, even though different classes of service can be purchased in each and every one of those travel industry services.

Why should the airline industry, which has been hemorrhaging since the beginning of this decade, be the only travel industry component that must bear the cost of this proposed change in deduction policy? Travel in business or first class is not undertaken on a lark by business travelers. Many businesses allow their employees to travel in first or business class because the seating and table space are more conducive to work. Oftentimes corporate policies limit the use of first or business class only to flights of greater duration or distance. Such travel is particularly preferred by business travelers on international flights. In general, they can rest more comfortably and be better equipped to handle their responsibilities at their international destination.

In each of these situations the business travelers made a legitimate business decision to purchase extra space in which to work or sleep. The proposed change in the deductibility of first class fares will have a devastating impact upon the revenue generated by the class of service. A far higher proportion of passengers in a first class cabin has paid full fare for their seats than do passengers in coach. Moreover the average yield for first class passengers is 17.5 percent higher than that for a coach class passenger. Consequently, driving passengers out of the first class cabin will appreciably harm airline revenues and will place additional pressure on airlines to cut flights, reduce work schedules, and diminish capital expenditures, particularly aircraft orders. There does not appear to be any rationale to disallow an otherwise lawful business deduction and penalize an otherwise commonly accepted business practice.

In addition, from a tax policy standpoint, the proposal should not be adopted because of its clear propensity to distort competition in the marketplace. Deductions for travel on charters, corporate aircraft or airlines which offer only one class of service are not limited by the legislation. Thus, airlines which offer multiple classes of service and thereby respond to different consumer needs would be penalized and first-class-only carriers rewarded.

From an administrative perspective the proposal would be an accounting nightmare. It would create a layer of complexity both for taxpayers and the Internal Revenue Service.

Business travelers, corporate travel departments and the IRS will be forced to monitor not only the first class fare paid but also the coach price of a ticket for the flight taken and the availability of a coach seat. Identification of the cost of a coach ticket is not easy in the competitive air travel market. The price of a coach ticket may change between the time the traveler makes his reservation and the time he takes his flight. By the time a company is audited, reliable data identifying the difference between the coach fare and the first class fare is unlikely to exist.

Further compounding the problem would be the situation faced by a last-minute traveler whose only means of access to a specific flight is to purchase a first class fare. Under the terms of the proposal would a business deduction be available for the difference between first and coach class? Even if a deduction were to be allowed in such a circumstance, record keeping requirements would be intolerable.

The Air Transport Association strongly opposes this legislation and recommends that the proposal not be adopted because of its negative impacts upon the airline industry, the traveling public and the Federal Government.

Mr. Chairman, my written statement covers two of the other proposals which others far more qualified than I have already addressed earlier today. Thank you very much for this opportunity.

Mr. HOAGLAND. Thank you, Mr. Merlis.

[The prepared statement follows:]

Statement of Edward A. Merlis
Senior Vice President, External Affairs
Air Transport Association of America
Before the Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives
Concerning Miscellaneous Revenue Issues
September 8, 1993

I am Edward Merlis, Senior Vice President of the Air Transport Association of America. I appreciate this opportunity to appear before you today to discuss three revenue measures that will have a substantial impact upon the financial health of the 17 U.S. air carriers who are members of the Air Transport Association. These airlines carry over 96 percent of the revenue passenger miles and transport over 97 percent of the freight carried by U.S. flag airlines.

The airline industry is currently facing desperate financial times. Having suffered unprecedented losses since 1990, airlines have parked aircraft, slashed capital orders, and furloughed workers. As a result, earlier this year the Congress established a National Airline Commission to investigate, study, and make policy recommendations about the financial health and future competitiveness of the U.S. airlines and aerospace industry. The Commission has now completed its report and documented industry - wide losses of $ 10 billion over the last three years.

Among the negative influences on airline industry health cited by the Commission were "tax policies [which] often have had a major and adverse effect on the industry". Although the Commission concluded that "tax changes alone will not restore the industry to profitability," it did observe, without hesitation, that "we believe there are several tax provisions that impede the ability of the industry to return to financial health."

Thus it is with some chagrin, that the industry finds itself once again in the position of needing to address proposed changes to the tax code which would adversely affect the environment in which we operate, particularly in light of the Commission having identified Federal taxes totaling more than $ 1.5 billion per year that need to be cut -- measures which, in the Commission's words "violate reasonable principles of common sense and good public policy."

Instead of appearing here today in support of efforts by Congress to implement the recommendations of your Commission, we are here discussing a series of proposals which would exacerbate the financial strains on the industry and add to the tally of jobs lost in the airlines, aircraft and engine manufacturers, and the travel and tourism industries.

Deduction limitations for airline tickets.

The first proposal we wish to address amends the Internal Revenue Code to deny a business deduction for that portion of the cost of an airline ticket in excess of coach fare. While the proposal will be directed at the business traveler, the true burden will fall upon the airline industry itself. To the extent flyers switch to coach, as a result of the enactment of this proposal, the government does not gain any revenue and the airline industry loses much needed revenue. Assuming all business travelers who would otherwise travel in business or first class switch to coach class, the U.S. airline industry would lose $ 220 million per year and would in all likelihood lay off several thousand flight attendants. In actual practice, we do not know, however, whether those business travellers who would currently travel in business or first class will switch to a coach seat. Some may, in fact, choose to charter aircraft at greater cost to the Treasury and injury to the airlines.

This proposal is particularly objectionable to ATA member airlines because it arbitrarily singles out 1) travel from all other business expenses and 2) air travel from all other travel. The proposal clearly and unfairly targets the airline industry. Deductions for business expenses for other sectors of the travel industry such as hotels, cruise lines, trains and rental cars are not impacted by this proposal even though different classes of service can be purchased in each and every one of those travel industry services. Why should the airline industry, which has been hemorrhaging since the beginning of this decade, be the only travel industry component that must bear the cost of this proposed change in deduction policy?

Mr. Chairman, travel in business or first class is not undertaken on a lark by business travelers. Many businesses allow their employees to travel in first class or business class of an airplane because the seating and table space are more conducive to work. Often times corporate policies limit the use of first or business class only to flights of greater duration or distance. Such travel is particularly preferred by business travelers on international flights. In general they can rest more comfortably and be better equipped to handle their responsibilities at their international destination. In each of these situations the business traveler has made a legitimate business decision to purchase extra space in which to work or sleep while traveling.

The proposed change in the deductibility of first-class fares will have devastating effect upon the revenue generated by the class of service. A far higher proportion of passengers in a first class cabin have paid the full faire for their seats than do passengers in coach. Moreover, the average yield for a first class passenger is 17.5% higher than that for a coach class passenger. Consequently, driving passengers out of the first class cabin will appreciably harm airline revenues and will place additional pressure on airlines to cut flights, reduce their work forces, and diminish capital expenditures, especially aircraft orders. There does not appear to be any rationale to disallow an otherwise lawful business expense deduction and penalize an otherwise commonly accepted business practice.

In addition, Mr. Chairman, from a tax policy standpoint, the proposal should not be adopted because of its clear propensity to distort competition in the marketplace. Deductions for travel on charters, corporate aircraft, or airlines which offer only one class of service are not limited by the legislation. Thus airlines which offer multiple classes of service and thereby respond to different consumer needs, would be penalized, and, first class only-carriers, rewarded.

From an administrative perspective the proposal would be an accounting nightmare. It would create a layer of complexity both for taxpayers and the Internal Revenue Service. Business travelers, corporate travel departments and the IRS will be forced to monitor not only the first-class fare paid but also the coach price of a ticket for the flight taken and the availability of a coach seat. Identification of the cost of a coach ticket is not easy in the competitive air travel market. The price of a coach ticket may change numerous times between the time the traveller makes his reservation and the time he takes his flight. By the time a company is audited, a reliable data source identifying the difference between the coach fare and the first class fare is unlikely to exist.

Further compounding the problem would be the situation faced by a last minute traveler whose only means of access to a specific flight is to purchase of a first class ticket. Under the terms of the legislation, a business deduction would not be available for the difference between the first class and coach class ticket.

For these reasons the Air Transport Association strongly opposes this legislation and recommends that the proposal not be adopted because of its negative impact upon the airline industry, the travelling public, and the federal government.

Increased tariff on imported crude oil.

The proposal to increase the tariff on imported crude oil by 15 cents per barrel and refined petroleum products by 1-cents per gallon is unnecessarily harsh to the airline industry which must share the burden of the recently enacted transportation fuels tax at a cost to the industry of $506 million per year beginning October 1, 1995. The increased tariff will cost the airline industry an additional $40 million per year. It is akin to an increase in the transportation fuels tax, which the National Airline Commission said should not be imposed on the airline industry. Accordingly, the Air Transport Association recommends that the proposal not be adopted.

Amortization of advertising expenses.

The proposal to require a portion of advertising expenses be capitalized and amortized over a period of years should not be adopted. Capitalization is generally required in the case of assets which have a long useful life. Advertising campaigns for airline travel generally have a relatively short shelf life. They are run for a short period of time to capture an audience for a specific travel market or to announce new discount air fares. In addition, these ad campaigns serve to promote travel and tourism, which benefits the economy of every state in the U.S. As such, the expenses associated with airline advertising campaigns should remain currently deductible.

Each of the above proposals has a negative impact upon the financial health of the airline industry. The airline industry faces many hurdles as it tries to return to profitability. It does not need to face additional costs resulting from new tax rules which impact its business operations and expenses.

Mr. HOAGLAND. Mr. Schmidt.

STATEMENT OF HENRY W. SCHMIDT, JR., PARTNER, KPMG PEAT, MARWICK, ON BEHALF OF CALIFORNIA LEAGUE OF SAVINGS INSTITUTIONS

Mr. SCHMIDT. Thank you, Mr. Chairman. My name is Henry Schmidt. I am a partner with KPMG Peat, Marwick, a public accounting firm. I am appearing here today on behalf of the California League of Savings Institutions. They represent some one-third of the Nation's thrift assets and 9 of the 10 largest thrift institutions in the United States. I am testifying today on the proposal to treat mortgage points as earned for tax purposes when a loan is originated.

League members were surprised at this proposal, specifically because just 7 months earlier the Treasury Department issued a proposed regulation dealing with the same issue and that Treasury regulation proposes to treat mortgage points in accordance with their economic substance. The issue involves a form of circular flow of cash and involves the question of when one individual element of a lending transaction, in this case points, as earned. We have submitted a more thorough written statement.

My comments today are intended as a brief overview. A little bit of history. Almost 40 years ago the Internal Revenue Service first published industrywide guidance to lenders in the mortgage business regarding the treatment of mortgage points. This has been readdressed by the IRS and Treasury from time to time and fine tuned in major industrywide rulings in 1964 and 1970, and it was the subject of some 40 plus private technical advices issued to industry members during the 1980s.

During the course of this period, most industry members have adopted the IRS-approved methods as first indicated in 1953. Congress then addressed this issue in the 1984 Tax Act and expanded what have been called the economic accrual concepts, also known as original issued discount rules, to loans to individuals.

Proposed Treasury regulations issued in 1986 generally touched on this subject and then, as I said earlier, in December 1992 Treasury regulations were proposed that dealt specifically with mortgage loan points. The December 1992 proposed regulations eliminate any formalistic distinction in lending transactions between discount on loans and stated interest on loans, something the lending business has long understood.

During the 1980s, FASB, the private sector accounting body, also addressed the very same issue from a financial accounting perspective, and in 1987 the FASB published FAS 91, concluding that points did not represent immediate income but rather another form of yield. This is because FASB recognized that points compensate lenders over the entire term of a loan. The fact that one lender charges zero points and another perhaps two to three points with compensating differences in the stated interest rate is proof of this in the marketplace. So, the standard setters for financial accounting in the private sector, beginning in 1988, insisted on the deferral points over the life of a loan. This was then adopted by the SEC and all bank regulatory and thrift regulatory bodies, and is today the financial and regulatory accounting law of the land. Through a combination of FAS 91 and these Treasury-proposed regulations, we have now arrived at consistent treatment of points by all Federal agencies that have examined the subject.

The proposal before this committee would reverse this 40-year process. We can only speculate that the proposal is perhaps intended solely to raise revenue and not based on sound tax policy nor a particular understanding or appreciation of the economic substance of lending transactions. Perhaps the proposal is also an effort to address continuing disputes between mortgage lenders and the Internal Revenue Service, as evidenced by some recent tax court activity. We think the source of disputes has already been resolved with the publication of the December 1992 proposed regulations. In fact, we feel treating points as different from stated interest economically will only prolong disputes and cause new ones into the future by encouraging the elevation of form over substance.

The California League of Savings Institutions opposes this return to form over substance. Thank you.

Mr. HOAGLAND. Thank you, Mr. Schmidt.

[The prepared statement follows:]

CALIFORNIA LEAGUE OF
SAVINGS INSTITUTIONS

September 8, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee On Ways And Means
U. S. House Of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Hearings On Miscellaneous Revenue Provisions - Comments On Proposal To Tax Mortgage Lenders On The Receipt Of Points

Dear Ms. Mays:

We are responding to your request for public comments on the miscellaneous revenue proposals that will be the subject of hearings scheduled for September 8, 1993. We are particularly concerned with the proposal that would require thrift institutions, or, in the alternative, all mortgage lenders, to include in income at the time of receipt points paid in connection with mortgage lending transactions. The California League of Savings Institutions is the trade association representing the savings institutions of California. Our members hold one third of thrift assets nationwide and include nine of the ten largest savings institutions in the country.

We strongly recommend that the subcommittee reject this proposal. To require mortgage lenders to include points in income upon receipt would be discordant with the underlying economic substance of mortgage lending transactions, and would not represent sound tax policy.

Points paid by a borrower in a lending transaction do not represent economic income to a lender. The Treasury Department and the Internal Revenue Service (hereinafter, "IRS") affirmed that points do not economically represent income to a lender in proposed regulations promulgated December 22, 1992.[1] The proposed regulations reflect the economic reality that points represent a reduction in the net loan proceeds disbursed by the lender to or on behalf of the borrower at closing.

As is explained in greater detail below, the Treasury Department's and the IRS's decision to treat points in accordance with their economic substance was made only after extensive deliberation of the proper treatment of points. In fact, the decision to treat points in accordance with their economic substance reverses the IRS's long-standing position as expressed in their published rulings, their position as litigated in the courts, and their position as espoused in proposed regulations issued in 1986.

Failure to tax financial transactions in accordance with their economic substance invariably leads to controversies between taxpayers and the IRS that turn upon the form in which a taxpayer casts a transaction. If the proposal is adopted, the subcommittee can be assured that economically identical transactions will receive disparate tax treatment.

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[1] 57 Fed. Reg. 60750, 1993-3 I.R.B. 21.

9800 S. Sepulveda Boulevard
Suite 500
Los Angeles, CA 90045-0054
Telephone 310 670 6300
FAX 310 410 0372

Background

Loan origination fees, or points, may be charged by mortgage lenders in loan origination and refinancing transactions. Points, if charged, are computed as a percentage of the face amount of the loan, each point being equal to one-percent of the face amount of the loan. Generally, the interest rate on residential mortgage loans that require the payment of points is lower than the rate on residential mortgage loans that do not require points.[2] In charging points, a lender reduces its prepayment or reinvestment risk because the effective yield on a loan which required the payment of points increases if the loan is repaid early.

A borrower generally has several options in handling the payment of points:

- The borrower can pay points in cash at closing;
- The borrower can have the points withheld from the face amount of the loan and receive only the net proceeds at closing; or
- The borrower can have the points added to the face amount of the loan, but receive only the gross amount of the loan net of the points.

Economically, the three transactions are equivalent. For instance, there is no economic difference between a transaction in which an institution lends $200,000 to a borrower in exchange for a note with a face amount of $200,000 and receives $6,000 in points from the borrower at closing (i.e., the circular flow of cash), and a transaction in which the institution simply lends $194,000 to the borrower in exchange for a note with a face amount of $200,000. The tax law however, has not always recognized this equivalence.

In Rev. Rul. 70-540,[3] the IRS set out five situations concerning the proper tax accounting for fees received by lenders in various mortgage lending transactions. Situation 1 parallels the first transaction described above in that the borrower paid the points to the lender with "fresh funds." The ruling holds that the lender must include the points in income upon receipt. In Situation 2, the borrower did not pay the points at closing, but instead, the lender increased the principal balance of the loan by the amount of the points. Here, the ruling holds that the points are includible in income by the lender ratably as payments are made on the loan.

Rev. Rul. 70-540 appears, therefore, to have drawn a bright line. If a borrower paid points with "fresh funds," the points would be treated as the receipt of income by the lender. If, on the other hand, the lender simply withheld the points from the loan proceeds, the points would be viewed as having been financed and would be taken into income over the life of the loan as the borrower made payments.

Notwithstanding the apparent bright line drawn by Rev. Rul. 70-540, numerous controversies arose between the IRS and lenders concerning the proper tax treatment of points. The issue raised in these controversies was whether, in any given transaction, the borrower had in fact paid points with fresh funds, thereby requiring current income recognition by the lender. For example, assume a borrower agreed to pay $150,000 for a new home, and asked the lender to loan $135,000 (other closing costs and escrow charges will be disregarded). The lender agreed to make the loan but charged the borrower one point ($1,350). At closing, the borrower would pay to the escrow agent $16,350. The lender would disburse to the escrow agent $133,650. ($135,000 loan amount less the $1,350 in points charged the borrower). Even the most astute observer has difficulty in determining whether the points were discounted from the loan proceeds or paid at closing unless the loan documents clarify whether the points are paid up front or financed.

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[2] For example, a mortgage lender in the Washington, D.C. metropolitan area recently quoted interest rates for 30 year residential mortgages as either 6.75 percent plus one point, or alternatively, 7.125 percent and zero points.

[3] 1970-2 C.B. 101

The Tax Court in 1991 faced this dilemma. Based on the unique facts in a particular lenders case, it upheld the IRS's determination that the lender had received the points in cash and must include the "prepaid interest" (points) in income because the lender's loan documents did not contain an agreement to finance points.[4] Notwithstanding the Tax Court's decision on the specific issue of points, and other precedent requiring the taxation of prepaid income[5], the Treasury Department and the IRS subsequently determined that points do not economically represent prepaid income and should be treated as a reduction in the issue price of a debt instrument.

The Proposed OID Regulations

On December 22, 1992, the IRS revised previously proposed regulations interpreting the original issue discount (OID) provisions found in sections 1271-1275 of the Internal Revenue Code. Generally, OID is the difference between a debt instrument's issue price and its stated redemption price at maturity. Section 1272 requires the inclusion of OID in a holder's income as it accrues without regard to the holder's method of accounting. The proposed regulations provide detailed rules for determining the issue price and stated redemption price at maturity for debt instruments.

As indicted above, the proposed OID regulations provide specific rules dealing with a borrower's payment of points in a cash lending transaction.[6] These regulations provide that any payment from a borrower to a lender (other than a payment for services provided by the lender, such as commitment fees or loan processing costs) reduces the issue price of the debt instrument evidencing the loan.

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[4] Bell Federal Savings and Loan Assn. v. Commissioner, T.C.M. 1991-368, addressed this issue. The court held that the points were in fact paid any time the borrower brought fresh funds to closing in an amount sufficient to cover the points.

[5] Generally, prepaid income for services must be included in income when it is paid. Schlude v. Commissioner, 372 U.S. 128 (1963) (advance payments for dance lessons); American Automobile Association v. United States, 367 U.S. 687 (1961) (prepaid dues); RCA Corporation v. United States, 664 F.2d 881 (2d Cir. 1981, cert. denied, 457 U.S. 1133 (1982) (television service contracts). The IRS has determined, however, that the method of accounting prescribed in the above-cited cases (prepayments are income upon receipt) does not clearly reflect income in the case of lump sum payments received with respect to notional principal contracts. Notice 89-21, 1989-1 C.B. 651; Prop. Treas. Reg. § 1.446-3(e)(3)(ii). These IRS releases recognize that financial instruments that require performance over a fixed period of time are fundamentally different from service contracts where the amount and timing of future services is not fixed but is solely within the discretion of the purchaser.

[6] Prop. Treas. Reg. § 1.1273-2(j).

Further, the regulations make it clear that the payments of points by a party other than the borrower (e.g., the seller) will also be treated as a reduction in issue price.

Thus, by charging points on a loan, a lender is treated as issuing the loan at a discount. Generally, the lender must treat the discount as OID and take it into income based on the loan's yield to maturity over the life of the loan.[7] The loan's yield to maturity is the discount rate that when applied to the stream of payments to be made on the loan produces an amount equal to the loan's issue price.[8]

We believe the treatment in the proposed OID regulations of cash points incident to a lending transaction results in the proper economic treatment and is supported by and consistent with the tax policy that led to the overhaul of the OID provisions of the Code as part of the Deficit Reduction Act of 1984 (DRA 1984).

Congress recognized in enacting DRA 1984 that debt instruments should be taxed in accordance with their economic substance.[9] Because, from an economic perspective, income accrues on a loan at a constant rate over the life of the loan, Congress adopted tax rules that paralleled economic accrual. Taxpayers were thereby prevented from structuring loans that front-loaded or back-loaded taxable income. Requiring a lender to take points into income at closing would, of course, result in an extreme front-loading of income on that loan and would, therefore, be entirely inconsistent with the tax policy underlying the OID rules.

Furthermore, if the position taken by the IRS and Treasury in the proposed regulations is rejected, and lenders are forced to treat points paid by borrowers as income upon receipt, controversies will once again arise between the IRS and lenders as to whether points are paid or discounted. Such controversies are expensive for both taxpayers and the government, and their outcomes typically depend upon subtle nuances in the form of a transaction rather than any issue of economic substance.

Section 461(g)

Although we can only speculate concerning the reasons for the proposal to require current inclusion of points in a lender's income, it may be that the proposal's sponsor was concerned that failure to tax points upon receipt would provide asymmetrical tax treatment for borrowers and lenders. Generally, section 461(g) prohibits a cash method taxpayer from deducting prepaid interest. Section 461(g)(2), however, provides that this prohibition does not apply to points paid in connection with a loan for the purchase or improvement of a principal residence if the loan is secured by the residence. Points paid on loans to refinance an existing loan, and points paid on loans whose proceeds are not used to acquire or improve a principal residence (a home equity loan to buy a car) are not eligible for deductibility under section 461(g)(2).

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[7] Prop. Treas. Reg. §§ 1.1273-1 and 1.1272-1. If, however, the amount of OID on a debt instrument is de minimis (less than .0025 times the weighted average maturity of the loan, or less than .00167 times the number of complete years to maturity), then OID is recognized as the borrower makes principal payments.

[8] Prop. Treas. Reg. § 1.1272-1(b)(1)(i).

[9] See generally Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 108-127.

Congress enacted section 461(g) to prevent abusive tax shelter transactions in which interest expense was front-loaded.[10] As indicated in the discussion of the OID provisions, front-loading of interest is inconsistent with the economic accrual of income on debt instruments. Apparently, Congress, as a matter of legislative grace, enacted section 461(g)(2) to allow a deduction for prepaid interest (points) in residential lending transactions to facilitate the purchase of residential real estate. Neither section 461(g)(2) nor its legislative history suggests that Congress intended that symmetry exist between the timing of the borrower's deduction of points and the lender's inclusion of the points in income. As indicated above, the proposed OID regulations would treat all points received by the lender as a reduction of a loan's issue price regardless of whether the borrower is allowed to deduct the points under section 461(g)(2).

No need exists for symmetry between the borrower's deduction of points and the lender's inclusion of points in income. The treatment of points as a reduction of issue price is appropriate as a matter of tax policy because it treats points in accordance with their economic substance. Section 461(g)(2) represents a decision made by Congress for a valid non-tax policy reason (encouraging home ownership) to treat a borrower's payment of points in a manner that does not accord with the economic substance of the underlying mortgage lending transaction. Thus, no tax policy would be served by requiring lenders to include points in income solely because some borrowers can deduct those points under section 461(g)(2). Moreover, requiring current inclusion of points in a lender's income will created asymmetry for all loans other than those subject to the special provisions in section 461(g)(2).

Conclusion

To reiterate, we strongly recommend that the subcommittee reject the proposal to subject lenders to tax upon the receipt of points paid incident to mortgage lending transactions. Transactions should be taxed in accordance with their economic substance, which in this case requires treatment of points as a reduction in the issue price of the loan to which the points relate.

Mr. Henry Schmidt, partner in the accounting firm KPMG Peat Marwick, assisted in the drafting of this comment letter and is scheduled to testify on behalf of the California League at your hearings on September 8, 1993.

Sincerely yours,

Louis H. Nevins

Louis H. Nevins
President

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[10] See H. Rep. No. 658, 94th Cong. 1st Sess. 97 (1976), 1976-3 (Vol 2) C.B. 789.

Mr. HOAGLAND. Mr. James O'Connor.

STATEMENT OF JAMES E. O'CONNOR, TAX COUNSEL, SAVINGS & COMMUNITY BANKERS OF AMERICA, PRESENTING TESTIMONY FOR MICHAEL PALKO, SENIOR VICE PRESIDENT AND DIRECTOR OF CORPORATE TAX, GREAT WESTERN FINANCIAL CORP. ON BEHALF OF THE SAVINGS & COMMUNITY BANKERS OF AMERICA

Mr. O'CONNOR. Mr. Chairman, members of the committee, good afternoon. My name is James O'Connor. I am the tax counsel of the Savings and Community Bankers of America. The Savings and Community Bankers of America is the trade association of more than 2,000 federally and State-chartered stock and mutual savings banks and savings and loan associations.

Mr. Chairman, I am testifying as well in opposition to the revenue proposal before the subcommittee that would require thrift institutions to take into income when received points on single family mortgages or alternatively to require all mortgage originators to take such points into income when received. This proposal in either form would single out for unfair treatment thrifts that originate mortgages and hold them in portfolio.

Mortgage bankers and thrifts that sell mortgages they originate would not be affected by the proposal because of the fact that the mortgages they originate are disposed of shortly after origination, making this proposal irrelevant in denying a lender the right to accrue points over the holding period of a loan. Points are computed as a percentage of the face value of a note, each point being equal to 1 percent of the face value.

The points referred to in the proposal are an adjustment to the stated interest rate of a loan to reflect the actual costs of borrowing funds. The determination of when points are received has been one of the single greatest sources of controversy in the IRS examinations of thrift institutions. Before 1970 many thrifts had received rulings permitting them to accrue points over the life of the loan. The controversy began in 1970 with the publication of an IRS revenue ruling that sought to make the tax treatment of points by lenders dependent upon the form of payment by the borrower. Points that had been paid in cash at closing would be immediately included in the lender's income. If, on the other hand, the borrower received a loan disbursement equal to the face amount of the loan but reduced by the points, in other words if the points had been financed, the ruling permitted the points to be accrued over the life of the loan.

The controversy existed because the facts of almost every lending transaction are ambiguous, and the parties will be motivated to disagree as to whether or not the points are paid or financed. Lenders will be motivated to say that the points have been financed so that they can spread them. Borrowers, on the other hand, will be motivated to say that points were paid in cash so that they can deduct them up front under section 461(g)(2). Because of the IRS's desire for symmetry in the tax treatment of borrowers and lenders, the litigating position of the IRS has been that in order for lenders to accrue points, the loan documentation must evince a clear understanding of the parties that the points are being financed.

In practice, however, IRS agents created symmetry between borrower and lender by insisting that any funds brought to closing went first to pay points. The 1970 IRS ruling created a 20-year controversy that was without economic substance, and that undercut the subsidy that Congress had granted to home buyers in section 461(g)(2). Economically it makes no difference whether a lender disburses $98 in exchange for the borrower's $100 note or the lender disburses $100 in exchange for the $100 note and the payment of $2 either from the loan proceeds or from the borrower's separate funds. The cash payment of $2 is simply a reduction of the amount loaned.

The IRS view that if the borrower were taking a deduction for paying points, the lender should include the points in income failed to appreciate that the borrower's deduction was a subsidy for home buyers that had nothing to do with the economics of the transaction. To require the lender to make up the revenue lost by the subsidy was unfair to the lender. In fact, it can be argued that by raising the cost of lending, the IRS undercut the subsidy because some portion of that increased cost had to be passed along to the borrower. The IRS position on loan points was heavily criticized by authors and practitioners and after thorough reconsideration the Treasury and IRS clearly and unequivocally reversed the position taken in the 1970 ruling.

Proposed regulations published in December of last year interpreting the 1984 OID provisions state that even though points are paid in cash at closing, they represent a reduction of the loan amount that will be accrued as original issue discount over the life of the loan. These proposed regulations are expected to be published in final form shortly. If the subcommittee were to adopt the current proposal and contravene Treasury's position in the proposed regulations, it would be setting the stage to resurrect and perpetuate an insoluble controversy that has no basis in economic reality.

Once again, I would like to thank the committee for providing the opportunity to testify today, and I would be happy to answer any questions.

[The prepared statement follows:]

TESTIMONY OF MICHAEL PALKO
ON BEHALF OF THE
SAVINGS & COMMUNITY BANKERS OF AMERICA

Mr. Chairman, thank you for this opportunity to appear today before your Subcommittee. My name is Michael Palko and I am Senior Vice President and Corporate Tax Director of Great Western Financial Corporation, a multi-regional, consumer-oriented financial services company with a substantial mortgage lending business. I am speaking before the Subcommittee today as the representative of the Savings & Community Bankers of America. SCBA is the trade association of the more than 2000 member institutions comprising the savings associations and saving bank businesses, collectively referred to as thrift institutions. The membership includes all types of institutions -- federal and state chartered, stock and mutual.

Description Of The Proposal

I am here today to testify in opposition to a revenue raising proposal that unfairly singles out thrift institutions. This proposal would require thrift institutions to take into income points on single family mortgages when received or, alternatively, to require all mortgage originators to take such points into income when received. The proposal would effectively distinguish between points that have been paid and points that have been financed. Points that have been financed would be taken into income over the life of the loan. Those that have been paid by the borrower at closing would be taken into income by the lender when paid.

Both Forms Of The Proposal Single Out Thrifts

This proposal would essentially codify a form-over-substance view of lending transactions that has made their tax treatment uncertain, generated needless controversy and litigation, and thereby imposed significant administrative burdens on the IRS and costs on taxpayers. Conceptually, the proposal would mandate a difference in the tax treatment of lenders based on a distinction -- whether points are paid or financed -- that is factually ambiguous and, even if the distinction is made, is without economic significance. The Treasury in recently published proposed original issue discount regulations rejected this difference in tax treatment by prescribing consistent treatment for loan points regardless of whether they are paid or financed.

Even if the proposal were to be made applicable to all mortgage originators, its impact would fall almost exclusively on thrift institutions. Points may be charged on all types of loans, e.g., commercial real estate loans, consumer loans, business loans, as well as residential mortgage loans. The tax difference between treating points as paid at closing or financed is greatest in the case of residential mortgage loans because of the relatively long terms of such loans, assuming, of course, that the lender keeps the loan in portfolio. With respect to loans originated by mortgage bankers and those originated by thrifts for sale into the secondary mortgage market, the timing difference created by the proposal would be minimal because of the short time between the closing and sale of the loan. The proposal will, thus, confer a competitive advantage on mortgage banking operations and create an incentive for thrifts to emphasize zero-point mortgages.

The Proposal Is Unfair To Low-income Homebuyers

In addition to the unfairness to thrifts of this proposal, the proposal will be unfair to low-income and minority borrowers. Loans made to poor and minority borrowers are often categorized as "nonconforming loans" because the borrowers have not established sufficient credit and have spotty job histories. Nonconforming loans usually have to be kept in portfolio by the originating lender because they are not considered suitable for sale into the secondary mortgage market. In fact, these are sound loans and it is only the narrow standards of suitability of the formal secondary mortgage market that limit their marketability. Thrifts, as has been reported in the press, have a much better record than other lenders, of making mortgage loans to low-income borrowers. In part this better record is attributable to the fact that thrifts can and are willing to hold in portfolio loans that the secondary mortgage market is unwilling to buy.

Enactment of the proposal before this Committee, which subjects mortgage loans held in portfolio to disadvantageous tax treatment, would be an additional disincentive for thrifts to make the kinds of loans that are often made to low-income homebuyers. At the very least, implementation of this proposal may deprive low-income borrowers of the opportunity to negotiate a lower rate in exchange for paying points, because institutions will be forced to consider limiting the availability of points on portfolio loans.

The Proposal Would Continue An Insoluble Controversy

Points or, more technically, loan discount fees are amounts charged borrowers by lenders as a percentage of the face amount of a loan -- each point equaling one percent of the face amount of the loan. As the term is generally understood and used, points are "amounts paid for the use and forbearance of money," in other words, interest. (Rev. Rul. 70-540, 1970-2 C.B. 101.) Points, in this sense, are to be distinguished from commitment fees and loan origination fees paid for services. Points are effectively a yield adjustment, with the inverse relationship between the stated rate of interest and the amount of points reflecting, in addition to present value discounting, the offset of prepayment risk created by the increase in yield that results from prepayment where points are charged.

The proposal before the Committee would codify a distinction made by the IRS in Rev.Rul. 70-540, 1970-2 C.B. 101, as amplified by Rev. Rul. 74-607, 1974-2 C.B. 149, which specified the tax treatment of lender fees in five different situations. In the first situation described in the ruling, the lender disbursed the face amount of the loan and the borrower paid points from funds not obtained from the lender. The ruling provides that in this situation the lender must include the points in income when received if it is a cash basis taxpayer or at the earlier of receipt or establishment of the right to receipt if it is an accrual basis taxpayer. In the second situation presented in the ruling the loan amount included both the points and the purchase price. The ruling held that,in this situation, a cash basis lender would include the points in income ratably as principal payments are received and that an accrual basis lender would include the points at the earlier of the time that principal payments are due or received.

Unfortunately, both the ruling and the proposal before the Committee take a simplistic view. In reality, it can be very difficult to tell whether points have been paid or financed, but the IRS view of reality seems to have been colored by a perceived need to maintain symmetry in the tax treatment of borrowers and lenders. Particularly in the case of discounted loans, the result has been considerable controversy between thrifts and the IRS. In a discounted loan the lender disburses at closing a net check equal to the face amount of the loan reduced by the points charged and the borrower brings a check in the amount of the required downpayment and the points that have been withheld from the face amount of the loan. The problem -- whether this net disbursement is best described in situation "1" or "2" of Rev. Rul. 70-540 -- can best be illustrated by an example.

> Assume the sales price of a home is $130,000 and the borrower agrees to make a downpayment of $30,000. A lender agrees to lend $100,000 at a certain rate and two points. If the loan is discounted for the points, the lender will disburse $98,000 at closing in exchange for the borrower's $100,000 note. The borrower will have to bring a check for $32,000 to the closing.

Under these facts the lender will undoubtedly contend that the points were financed. The borrower, however, will be just as adamant that the points were paid in cash because he or she will wish to qualify for the up-front deduction of the points permitted under section 461(g)(2) of the Internal Revenue Code. In general, section 461(g) provides that cash basis taxpayers cannot deduct "prepaid interest," but paragraph (2) was added to permit points to be deducted when paid if paid in connection with the purchase or improvement of a principal residence.

Because the facts are often ambiguous and because of the Service's quest for symmetry, the litigating position of the IRS has been that the loan documentation must evince the clear understanding of the parties that the points are being financed; otherwise the points will be treated as paid at closing under an assignment of income theory. (See Bell Federal Savings and Loan Association v. Commissioner, 1991-368 T.C.M.) In practice, however, IRS Examination has been requiring the inclusion of points in the year of closing by treating any amounts paid by the borrower at closing as having gone first to pay points -- regardless of how clear and specific the loan documentation is that the points have been financed.

The result of the Service's attempt to determine the tax consequences of loan transactions based on an artificial distinction that is impossible to apply to an ambiguous reality has been: years of insolvable controversy between IRS examining agents and appellate officers; the revocation of a number of private letter rulings issued to thrifts under the authority of Rev. Rul. 54-367, 1954-2 C.B. 109 and Rev. Rul. 64-278, 1964-2 C.B. 120 that permitted the accrual of points using either the "composite" or "liquidation" methods; repeated frustration by IRS Examination of taxpayer requests to the IRS National Office for section 7805(b) relief to prevent retroactive revocation of such private letter rulings; and the continuous refusal by the IRS ~~National Office to review model loan documents and issue guidance as to acceptable~~ forms of such documents so that standards would exist for determining whether points are paid or financed. The effect of the proposal now before the Committee would be to perpetuate this controversy.

The Controversy Has No Economic Substance

Whether points are paid or financed by the borrower is a distinction without economic substance. A transaction in which the lender disburses $98 for the borrower's note of $100 is no different economically from a transaction in which the lender disburses the full $100 in exchange for the borrower's payment of $2 from the loan proceeds or from another source. In both cases the lender has advanced $98 to the borrower and will receive over the term of the loan a return on a $98 investment of $2 of discount plus interest on $100. The payment of $2 in the latter situation does not create immediate wealth in the lender, instead by lowering the actual investment of the lender, it just raises the yield on the investment without affecting the cash flow.

The recent history of the controversy over the tax treatment of points has been of a gradual movement toward a resolution that conforms the tax treatment to economic reality and reconciles the disparate treatment of borrowers and lenders by recognizing that it was created by political decisions. The means to this resolution has been the original issue discount regulations. The original issue discount rules of the Internal Revenue Code were made applicable to obligations of individuals, including residential mortgages, by the Tax Reform Act of 1984, effective for transactions on or after March 2, 1984. Section 1273(a) of the Code defines OID as the excess of the stated redemption price at maturity over the issue price of the debt. In a loan transaction the issue price of the debt is the amount of money loaned. Original issue discount (OID) may be thought of functionally as interest denominated as principal. In general, OID is required to be recognized over the term of the obligation using an economic accrual method.

On April 8, 1986, the Treasury published proposed regulations (51 FR 12022) interpreting the changes to the OID provisions made by TRA 1984. Section 1.1273-2(f)(2) of the 1986 proposed regulations took a significant theoretical step toward conforming the tax treatment of points to economic reality by providing that cash payments from the borrower to the lender at the time of the loan -- providing the payments are not for services -- will generally reduce the issue price of the loan and, thus, create OID. The practical effect of the 1986 proposed regulations in eliminating the points controversy was, however, nullified by two exceptions.

The first exception, section 1.1273-2(f)(1) of the 1986 proposed regulations, provided that the payments by the borrower do not reduce the issue price if they are points that are deductible under section 461(g)(2). No explanation was provided in the proposed regulation for the creation of this exception, although it has the effect of maintaining symmetry of tax treatment between borrower and lender. That a need to maintain such symmetry motivated the drafters of the proposed regulation can be inferred from the treatment of the lender where the seller pays the points. Economically it is irrelevant to the lender whether points are paid by the buyer or seller, but it is very relevant to the lender's tax treatment.

Section 1.1273-2(f)(5) of the 1986 proposed regulations provided that a payment of points by the seller may be recharacterized as a payment from the seller to the buyer followed by a payment to the lender. The same paragraph also provided, however, that section 461(g)(2) will not apply to the amount recharacterized, so that points paid by the seller will reduce the issue price of the loan and create OID. The treatment of seller-paid points in the 1986 proposed regulations provides further evidence that elevating form over substance in the tax treatment of points creates inconsistent treatment for transactions that are economically the same.

Creation of the exception in the 1986 proposed OID regulations that prevented points that are deductible by the borrower from creating OID in the hands of the lender was a mistake. The immediate deductibility of points under section 461(g)(2) was a subsidy created by Congress for homebuyers. It was a mistake for the IRS to require symmetrical treatment of points by lenders based on a provision that created a subsidy by a departure from sound tax policy. In fact, this imposition of symmetry reduces the value of the subsidy to the extent that the increase in the lenders' tax is passed on to borrowers.

The second exception, also in section 1.1273-2(f)(1), provides that if the OID is de minimis, the amount of OID will be treated zero and prior law will continue to apply. This provision was actually intended to be an administrative convenience to taxpayers permitting the holder of the debt obligation to avoid having to include any OID in income until the principal payment was received and to possibly permit the OID to be treated as a capital gain. The effect in the case of points charged on residential mortgages, however, was to continue the controversy over whether they were paid or financed.

Liberalized Treatment Of Borrowers

As an ancillary matter, if the proposal before this Committee were to be enacted, it is possible the treatment of lenders would be even more unfavorable than it was for most of the years of controversy. Ironically, this result could occur because of a benefit recently conferred on borrowers by the IRS. In Notice 90-70, 1990-2 C.B. 351, the IRS adopted for the benefit of borrowers the "fresh funds" approach that IRS Examination has been using informally for some time to deny lenders accrual treatment of points even where the facts indicate the parties intended to finance the points. Notice 90-70 provides that any funds brought to closing for any purpose by the borrower will be deemed to be used first to pay points.

Conceivably, if the IRS had continued to insist on symmetry in the treatment of points, or if the proposal before the Committee were to be enacted, creating a fiction of points payment on the borrower's tax return could be used against the lender. Although no inference was made in the notice with respect to the treatment of points by lenders, imposing symmetry on lenders consistent with the treatment of borrowers under the notice would only be an extension of the symmetry previously insisted upon with the treatment of borrowers under the general provisions of section 461(g)(2).

The IRS Conforms Tax Treatment To Economic Reality

In the years following their publication a number of practitioners and authors criticized the 1986 proposed OID regulations for the section 461(a)(2) and de minimis exceptions. (See e.g., Garlock, Federal Income Taxation of Debt Instruments, Prentice Hall, 2d edition, at pp. 79-80 and Peaslee and Kleinbard, The Treatment of Deferred Loan Fees Paid To Thrift Institutions, Tax Notes, January 16, 1989, pp. 377-80.) After long and careful reconsideration, the Treasury on December 22, 1993, reproposed the OID regulations. (See 57 FR 60750.) The new proposed regulations completely conformed the treatment of points by lenders to economic reality, first, by making borrower deductibility of points under section 461(g)(2) irrelevant and, second, by completely refocusing the de minimis rule of the 1986 proposed regulations.

Section 1.1273-1(d)(1) of the new proposed regulations once again provides that if the amount of OID is less than a de minimis amount, there will be zero OID. It should be noted that the points charged in connection with the typical residential mortgage loan will be de minimis under the definition of section 1.1273-1(d)(3). Unlike the 1986 proposed regulations, however, that simply threw the lender back on prior law if the points were de minimis, section 1.1273-1(d)(6) of the new proposed regulations provides that the lender may include a proportional amount of de minimis OID with each principal payment. It may be said that the new proposed OID regulations have brought the controversy over the treatment of points by borrowers full circle. The method authorized for the accrual of de minimis points is the same liquidation method (but on an individual loan basis) that was authorized for cash basis taxpayers by the IRS in a number of private letter rulings under the authority of Rev. Rul. 64-278, 1964-2 C.B. 120. These rulings were then revoked by the IRS during the subsequent years of controversy. In addition, under the new proposed regulations, the fact that the mortgage provides for a teaser rate or interest holiday is no longer likely to make the de minimis exception unavailable. It is expected that the 1992 proposed OID regulations will be made final very soon.

Conclusion

SCBA strongly urges the Committee to reject this proposal to tax points in the year received. This proposal would only perpetuate an insoluble controversy that has been draining the resources of both thrifts and the IRS. It is a controversy that should be irrelevant as a matter of sound tax policy as it is irrelevant in terms of economic reality. In fact, the proposal is inconsistent with sound tax policy and would codify a position that the Treasury has just rejected after thorough deliberation and debate. In addition, to the extent the proposal provides a disincentive to make loans that must be held in portfolio, it may discourage community-minded institutions from making loans to low-income homebuyers that are not readily salable into the secondary mortgage market.

I would like to thank the subcommittee for the opportunity to testify today and would be happy to respond to any questions you may have.

Mr. HOAGLAND. Well, thank you, Mr. O'Connor.

Mr. McCrery.

Mr. McCRERY. No questions.

Mr. HOAGLAND. Mr. O'Connor, as your testimony recognizes, borrowers are often able to deduct points, such as home mortgage points when paid. If lenders can delay the recognition of such income, doesn't the Federal Treasury get shorted both ways?

Mr. O'CONNOR. I think we have to look at what is happening economically. It is no different whether you finance points, as I say, disbursing net amount of $98 in the case of a $100 note as opposed to the borrower paying $2 of points in that situation—pardon me, the lender disbursing a $100 note, the borrower perhaps taking $2 from that $100 note and using it to pay the points.

Economically you have what Mr. Schmidt called the circular flow of funds that in other contexts the code is quick to ignore. All we are saying here is that same concept of ignoring a flow of circular funds should also be recognized.

Mr. HOAGLAND. But is the Treasury getting shorted at both ends under the——

Mr. O'CONNOR. The Treasury said they were not. The proposed regulations issued in December 1992 said that the treatment I am advocating here is the proper treatment. This is good tax policy. This is the same treatment that the FASB has advocated; the same treatment that the SEC also has adopted.

Mr. HOAGLAND. Mr. Schmidt, the claim of right doctrine provides the prepaid income should be recognized when received. Shouldn't this doctrine be applied to the receipt of points?

Mr. SCHMIDT. No, I think the analysis goes back to a Supreme Court case involving advanced payment for dance lessons, and the issue there was whether the free use of the funds by the dance company in fact caused the taxation to occur at that time. Lending transactions have been considered seriously on an economic basis for the last 40 years, and are viewed, I think, quite differently than the kind of transaction that was considered in the dance case.

In all lending transactions if you make a distinction in one particular element, you create disparities in the parallel treatment with all other lending transactions, so in a 40 year period after thorough study and debate, it was concluded that the circular flow of cash represented by this type of transaction, as any other lending transaction should be viewed on the economics. That was viewed by every regulatory body and came to the same single conclusion, so I don't think a parallel to a dance company case is relevant for the lending business.

Mr. HOAGLAND. Let me thank you, by the way, for flying in for this hearing today, and let me ask you about a problem that California experiences I am sure as great a frequency as any other State. What else can Congress do to encourage institutions to make so-called nonconforming loans to low income borrowers besides allowing thrifts to defer income recognition on points?

Mr. SCHMIDT. I am not sure I am the right one to answer that unfortunately. I don't know if Jim has a comment.

Mr. O'CONNOR. I think the biggest single thing that can be done is to persuade, to encourage the secondary mortgage market, GSEs, Fannie, Freddie, and so forth to relax somewhat, to be more flexible in the standards they use for deciding whether or not a loan is suitable for sale. I think this is probably the single biggest constraint on institutions that would like otherwise to make loans that are sound, loans that they have assessed the risk on and are prepared to make, but have no choice but to hold in portfolio.

Mr. HOAGLAND. Thank you, Mr. O'Connor. Mr. Schmidt, do you have any response to that?

Mr. SCHMIDT. I agree with Jim's comments.

Mr. HOAGLAND. All right. Mr. Merlis, has this idea of disallowing the deductibility of first class airfares been floated previously?

Mr. MERLIS. Well, a bill on this subject has been introduced previously, but there has not been a hearing on it. I am not aware of any revenue estimate and I am not aware of what behavioral patterns one would follow. If one assumes that the Tax Code drives behavior, then people would only fly coach so there would be no basic revenue improvement. That is not likely to happen. A variety of different kinds of behaviors are likely to take place, but we cannot predict them precisely.

Mr. HOAGLAND. All right. I gather from your statement that the increased tariff on imported crude oil is something that would not be helpful to your industry?

Mr. MERLIS. No. Six weeks ago we were hit with $500 million a year in increased costs, the transportation fuels tax. This $500 million a year is more than the airline industry has ever earned except four times. To add $40 million a year is certainly not going to help us get out of the trough.

Mr. HOAGLAND. Ms. Erlandson, what is your response to the problem raised by Mr. Alfers of Morrison and Foerster in his testimony about the unfairness of requiring current mining operations to pick up the cost of tailings and waste left by mines that had been closed down 15, 20, 30 years ago?

Ms. ERLANDSON. Well, I think ideally we could all go back in a time machine and appropriately make those mining companies pay for reclamation of the mining sites back then. However, we can't do that, so the question becomes what is the best of the options that remain. The other choice, of course, would be to make all taxpayers pay for it. I suspect many of the mining companies that continue to operate today probably were operating in some capacity then, and so it is probably worthwhile to continue to hold them somewhat responsible.

In addition, I think it should be noted that from my understanding from experts on mining law or on mining today that it is still not an environmentally perfect activity and that there continue to be, for example, huge masses of material.

Mr. HOAGLAND. But is there a guilt by association concern? I mean, let's take a mining operation that has conducted its affairs in an exemplary fashion for 20 years. Does it make sense to assign them the costs of some of their colleagues that haven't?

Ms. ERLANDSON. Ideally, no, I don't think you want to hold current people responsible for past behavior. Again, I would say that the alternative is to either leave the mines unreclaimed which have devastating effects on the localized areas or to sort of spread across the industry a relatively small charge. Of course, you don't want to put a current mine out of business for a previous activity. I am not certain what the best level of tax would be.

In the case of coal mining, for example, the companies continue to pay reclamation fees, I believe, that go into an abandoned mine land fund. My understanding is that that doesn't exist right now with hard rock mining, so that could be a model.

Mr. HOAGLAND. You also testified in support of the proposal to tax HCFCs. How harmful are these chemicals to the environment and are there readily available alternatives to these chemicals?

Ms. ERLANDSON. The answer to the first question, how harmful are they, is that they are not as harmful as the chemicals that they are now substitutes for, CFCs. However, they do continue to deplete the ozone layer, and as I said in my testimony, some of them deplete it as much as methyl chloroform which is a chemical that is currently taxed. In addition, HCFCs tend to be more damaging in the short run than they are over the long run, which is what the ODPs are based on or the rate of tax that they pay.

As for substitutes, there are some. I don't know that they exist for all use, but as experience with this tax shows, as the tax has gone up, substitutes have come on to the market. It is basically supply and demand. There are both ozone-safe alternatives and a chemical called HFCs which do not deplete the ozone layer that are available today, but tend to be more expensive than HCFCs and that is why users don't purchase them. They purchase HCFCs instead, so a tax would make HFCs more competitive.

Mr. HOAGLAND. I see. Well, thank you.

Mr. McCrery.

Mr. MCCRERY. Nothing.

Mr. HOAGLAND. Thank you for your testimony. Now we will begin panel seven.

All right. Let us begin with Ms. Lee Beard.

STATEMENT OF E. LEE BEARD, CHAIRWOMAN, BUSINESS WOMEN'S GOLF*LINK, AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, FIRST FEDERAL SAVINGS

Ms. BEARD. Good afternoon. I am Lee Beard. I am here today in my capacity as chair of Business Women's Golf*Link, which is headquartered here in Washington, D.C. I also in my 9 to 5 life serve as the president and CEO for First Federal Savings of Hazelton, Pa. Business Women's Golf*Link strongly supports the proposal to deny Internal Revenue Code section 501(c)(7) status to clubs that engage in discrimination, including gender discrimination, and to deny any preferential tax treatment for tickets to events at these clubs.

Section 501(i) of the code currently denies tax exemption to any organization for any taxable year if at any time during such taxable year the charter, bylaws, or other governing instrument of such organization or any written policy statement of such organization contains a provision which provides for discrimination against any person on the basis of race, color or religion. We believe that it is important to expand the section 501(i) definition of discrimination to include gender.

I would like to share with you my personal experiences as a businesswoman who has experienced discrimination by 501(c)(7) tax exempt clubs, as well as the observations of our members of Business Women's Golf*Link. Let me first tell you about BWGL.

Business Women's Golf*Link was founded earlier this year for the purpose of creating networking and golf-related educational opportunities for business women who play golf. Our membership is made up now of over 250 businesswomen in the Washington area. They are generally business owners and managers of companies. All of our members play golf. These are business people who utilize golf to establish or to maintain business relationships. The use of golf and tennis in building business relationships has successfully been done by men throughout our country, by having access to clubs which enjoy tax exemptions as providing social and recreational benefits in a nonprofit structure.

I know that if I call a client for an appointment, the access is certainly much more easy if I have a round of golf or a tennis match included in that. Statistics show that the largest portion of new golfers are women. Statistics also show that women and minorities are the fastest growing segments of our work force. We also know that women have an ownership position in 30 percent of the businesses in this country, and that position is growing to 50 percent.

Four out of every five businesses started in this country during the past few years are owned by women. Women are creating taxable revenue opportunities across our country. Businesswomen need to have access to the private clubs where business relationships can be built and where business is conducted. Many of the members of BWGL have clients and customers who are male. The current Internal Revenue Code allows tax exemptions and benefits to clubs where only the male members and guests can benefit from full use of the facilities and thus the tax exemption serves to sanction discriminatory practices.

The Internal Revenue codes were not designed to allow select groups of citizens to benefit from discrimination. On a personal basis, I was appointed several months ago to serve as the president and CEO for First Federal Savings in Hazelton, Pa. At the time of the appointment, the board of directors interviewed several candidates, male and female, for the position.

One of the expectations of the CEO, regardless of gender, was that the CEO would belong to a personal club for access to golf. That is where the business is conducted in the Hazelton community as it is in most communities. This club has allowed me to be a member and has accepted my dues on the same basis as the men, but I am not allowed to play golf on Saturday or Sunday mornings, not because of my handicap, not because of my skill, but simply because of my gender. We believe that is unfair. Skill is not the criteria that is used. We are concerned that by allowing tax exemptions for clubs such as this where the bylaws do not prohibit gender discrimination, but the rules and the practices do, the taxpayers of our country are providing a financial benefit for discrimination. The code does not address gender nor does it provide a means of rescinding the tax exempt benefits for clubs whose rules and practices are discriminatory in spite of clean bylaws and written policies.

At a time when our Federal deficit is extremely large, it seems inappropriate to provide tax benefits for discriminatory practices. Again, we are concerned with the practices and the rules, not just the bylaws. We believe that it is also important to not allow charitable organizations to host golf tournaments and tennis matches at clubs which discriminate. Tax benefits are received by individuals in those clubs. We think that it is important to add gender to the code so that discrimination covers not just color and religion but also gender.

I thank you for the time to address this issue with you today. Thank you.

Mr. HOAGLAND. Thank you very much, Ms. Beard.

[The prepared statement follows:]

TESTIMONY
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
SEPTEMBER 8, 1993
by: Ms. E. Lee Beard

Good afternoon.

My name is Lee Beard. I am here today in my capacity as the Chairwoman for the Business Women's Golf*Link headquartered here in Washington, D.C. I am also the President and Chief Executive Officer for First Federal Savings and Loan in Hazleton, Pennsylvania.

Business Women's Golf*Link strongly supports the proposal to deny Code section 501(c)(7) status to clubs that engage in discrimination (including gender discrimination) and to deny any preferential tax treatment for tickets to events at these clubs. Section 501(i) of the Code currently denies tax exemption to any organization for any taxable year if, at any time during such taxable year, the charter, bylaws, or other governing instrument, of such organization or any written policy statement of such organization contains a provision which provides for discrimination against any person on the basis of race, color, or religion. We believe that it is important to expand the Section 501(i) definition of discrimination to include gender.

I am here today to share with you my personal experiences as a business woman who has experienced discrimination by 501(c)(7) tax exempt clubs as well as the observations of the members of an organization of 250 business women who play golf at various clubs here in the Washington, D.C. area.

Let me begin by sharing with you the nature of Business Women's Golf*Link. BWG*L was founded early in 1993 for the purpose of creating networking and golf related educational opportunities for business women who play golf. Our membership is made up of over 250 women who own businesses or are managers in companies. All of our members play golf. The association is not discriminatory - there is a male member - but rather has been created for the purpose of providing support, primarily from an education standpoint, for business women who play golf . These business people often utilize golf to establish or strengthen business relationships. They often conduct business on the golf course.

The use of golf and tennis in building business relationships has been successfully done for years by men throughout our country by having access to clubs which enjoy tax exemptions as providing social and recreational benefits in a non-profit structure. Business men and women often find that if they call a potential client for an appointment the calendar is more accessible if the invitation includes a round of golf or a game of tennis. The use of a private club for meetings, meals and entertainment can be critical in business. Statistics gathered in 1991 by the National Golf Association and shared with vendors and the golf community during the first Women in Golf Summit sponsored by the LPGA reveal that the largest portion of new golfers are women. Information shared in the Department of Labor's report during the late 1980's regarding the Workforce 2000 reveals that women and minorities are the fastest growing segments of the workforce. In 1987 the National Organization of Women Business Owners reported that women had an ownership position in 30% of the businesses in this country and that is expected to increase to closer to 50% during the next few years. Four out of every five businesses started in this country during the past few years are owned by women. Women are creating taxable revenue opportunities across the country. Business women need to have access to the private clubs where business relationships can be built and where business is conducted.

Many of the members of BWG*L have clients and customers who are male. Business women who play golf are hindered from conducting business in the same way as their male peers when the private clubs discriminate against the business person for membership or access to the facilities of the club based on gender. The current IRS Code allows tax exemptions and benefits to clubs where only the male members and guests can benefit from the use of the facility and, thus, the tax exemption serves to sanction discriminatory practices. The IRS tax codes were not designed to allow groups of citizens to benefit from discrimination.

On a personal basis, I was appointed to serve as the President and Chief Executive Officer for a savings and loan in northeast Pennsylvania in early 1993. At the time of the appointment, the Board of Directors had interviewed several candidates, male and female, for the position. One of the expectations for the CEO of this institution, as is true for most banks, is to be a member of the area country club where most of the area business owners and officers are members. This particular club provides an important service to these business people as a place to conduct business in private during lunch or dinner, a facility for large group meetings and meals, and a place to entertain on the golf course or the tennis courts. The membership is open to area business men and women. The area does not have alternative facilities with the same services close by. Thus, this club has become the primary place for business people to meet, develop business contacts, and entertain. Membership by the CEO for my financial institution is important as a part of the business community. The Board recognized that I would benefit from the business contacts at this club especially since I am new to the community. One of the expectations of my appointment was membership in the club. I have been accepted as a member of the club in my name with a full golf family membership. I understand that I am one of less than ten women who are a member of the club. Most of these women also have family memberships.

After I was accepted as a member in the club the Board of Directors for the club considered a recommendation to change the rule which the club currently has which does not allow women to play on the golf course on Saturdays, Sundays and holidays prior to 1:00 pm. This rule also does not allow men to have tee times on Tuesday mornings nor women to tee off for a three hour period on Thursday afternoon. Each of these rules are open for the club golf professional to make exceptions to as he sees fit. The ruling for limiting access to the course on Saturday and Sunday mornings has prevented me from developing some business relationships. Development of relationships with the key business men in the community is important for my position as the CEO for the institution. The club's Board of Directors considered changing the rule to limit play on Saturday and Sunday mornings not based on gender but rather on primary membership. The Board voted not to change the rule. Thus, business women are still denied access to the golf course based on gender even if they can play as quickly as the men or if they have the same or a lower handicap as the men. Skill is not the criteria for play at many clubs. Gender is.

I am concerned that by allowing tax exemptions for clubs such as this, where the bylaws do not exhibit gender discrimination but the rules and the practices do, the tax payers of our country are providing a financial benefit for discrimination. The current IRS code does not allow discrimination based on race, color, or religion in the bylaws and written policies of clubs with a tax exemption. The code does not address gender nor does it provide a means of rescinding the tax exemption benefits for clubs whose rules and practices are discriminatory in spite of "clean" bylaws and written policies. At a time when our federal deficit is extremely large, it seems inappropriate to provide tax benefits for discriminatory practices.

I am here today to strongly urge the subcommittee to support the proposal to deny Code section 501(c)(7) status to clubs that engage in _gender_ discrimination, in addition to the current wording which defines discrimination for this section as being on the basis of race, creed, or color. I am also here today to urge that the subcommittee support denying section 501(c)(7) status to clubs whose _practices_, _customs_ or _rules_ as well as bylaws and written policies allow for discrimination based on gender, race, creed, or color.

While a club's bylaws might be "clean", i.e., have no discriminatory language, the club could still have practices, customs and rules (written or unwritten) which are discriminatory. We must be sure to close the "loopholes" sometimes utilized by clubs whose actual practices are more restrictive than their bylaws. I urge the subcommittee to add appropriate language which will not allow the 501(c)(7) nor any tax exemption to clubs whose charter, bylaws, policies, _rules, customs, or practices_ are discriminatory.

I believe that it is important to take away any tax benefits that clubs which discriminate enjoy. Two other benefits which clubs enjoy are the revenues provided by events conducted to benefit local or national charitable organizations and the revenues provided by business persons eating and entertaining at the club. The charitable organizations host events such as golf tournaments and tennis matches at clubs as fund raising events. The individuals purchasing tickets to these events are benefiting by deducting from their taxable income the portion of the ticket cost which is deemed to be a charitable contribution. Once again, a tax benefit is being provided to those who support clubs with discriminatory practices. Business people who deduct the cost of meals and entertainment at clubs with discriminatory practices are also enjoying tax benefits. Again, at a time when our nation's deficit is very high, it seems a shame that tax benefits are directly and indirectly being afforded to clubs with discriminatory practices.

I want to thank the committee for allowing me the time to discuss this important matter with you. I would be happy to answer questions which you might have at this time. If you or any of your staff members would like to contact me or Business Women's Golf*Link to answer any questions the Committee may have as this legislation is considered, please contact Ms. Patty Sheehan, President, at the Business Women's Golf*Link 3050 K Street, NW Suite 400, Washington, D.C. 20007 (phone 202-342-8631) or me c/o First Federal Savings P O Box 950 Hazleton, Pa. 18201.

Mr. HOAGLAND. Mr. Lehrfeld.

STATEMENT OF WILLIAM J. LEHRFELD, COUNSEL, PRESENTING TESTIMONY FOR EDWIN J. FEULNER, JR., PH.D., PRESIDENT, HERITAGE FOUNDATION

Mr. LEHRFELD. Mr. Chairman, my name is Bill Lehrfeld. I am the general counsel of the Heritage Foundation. I am substituting for Mr. Feulner, who was unable to meet this schedule when it was changed for the hearing. Mr. Feulner wanted to express his personal opposition to the proposed 30 percent excise tax on lobbying expenditures. The Heritage Foundation is a public policy research institution which does not engage in propaganda or attempt to influence legislation contrary to section 501(c)(3) of the Internal Revenue Code. It deals in the marketplace of conservative ideas and American ideals. It has no control over what others do to translate its research into concrete legislative proposals nor does it seek to advance or inhibit pending or proposed legislation once introduced.

Saying that is not to say it is in complete compliance with existing law. As the members of this committee know, section 501(c)(3) provides that no substantial part of our resources can be devoted to attempts to influence legislation. We do not know, nor does the Congress, nor the public, what secret rules the Internal Revenue Service uses and what tests are involved in determining what is an "attempt to influence" legislation and when advocacy of a legislative topic becomes "substantial." These rules, enacted in 1934, have been a constant source of friction and intimidation between the Internal Revenue Service and the charitable community. I believe that the public and the Congress would be better served by a repeal of the lobbying limits in 501(c)(3), its alleged liberalization in 501(h), and the repudiation of this proposal.

Herbert Hoover said that a good many things go around in the dark other than Santa Claus. One way to assure that Congress does not go around in the dark is to make it easy for the 501(c)(3) sector to communicate with the Members of Congress in as many ways as possible. One of the most efficient and enlightened ways to communicate with members is through charitable organizations which channel the views of their own constituency.

Today's proposal discounts the Congress because it seeks to deprive you of the resources for the conduct of your own responsibilities. Some of your own members would rather have you guess than know the information and ideas percolating in the public interest. In our opinion a retroactive excise tax on advocacy by charities is unacceptable tax policy and contrary to every principle of accountable Government contained in our Constitution.

The excise tax proposal seems to spring from the discredited notion that a tax exemption or deductible contribution is some form of Federal financial assistance and that as a price for such assistance it can control our Nation's intellectual resources. The Supreme Court recognized that Congress does not infringe on free speech when it disallows lobbying deductions nor does it deny the equal protection of the law to charities when it takes away their tax exemption, but not the tax exemption of veterans organizations which lobby on the same topic. However safe these precedents are from being overturned, it does not mean that an expenditure tax is safe.

Affecting tax exemptions or tax deductions involving excess lobbying is not the same as imposing an actual tariff on any lobbying. An excise tax on lobbying expenditures is an open suppression of constitutional rights because it taxes the very value of the lobbying message. Such a tax should not survive a constitutional challenge, but that aside, the real point is not the proposal's constitutional flaws, but that Congress should even consider enacting a law which plainly devalues itself and stigmatizes a fundamental freedom.

Do you believe that the public's confidence in its elected representatives is enhanced by tax policies evidenced by this proposal?

In conclusion, if all publicly supported charities, right, left, and center are free to participate in shaping the public policy, how can the public be the loser? Some Members of Congress may feel that they have too much to read on too many issues, but the Heritage Foundation believes that you have always benefited from your own conscientious efforts to widen the debate, to give unheard voices a hearing, and to distill from open, unfettered, and antagonistic comments the best approach to problems and the best avenues to solutions.

Allowing 501(c)(3) lobbying will not automatically accomplish that desirable goal, but it would signal a new openness, a welcomeness, if you will, to charities, to churches, and educational institutions to assume a rightful role in the legislative arena. As Thomas Jefferson noted in his first inaugural address, error of opinion may be tolerated where reason is left free to combat it. Fifty years of fear, ignorance, and intimidation cannot be reversed by the repeal of the lobbying limits today or the repudiation of this proposal. We want to make sure that errors of opinion may be fought by institutions of independence, fair partisanship, and sensitivity to our national well-being. Thank you, Mr. Chairman.

Mr. HOAGLAND. Thank you, Mr. Lehrfeld.

[The prepared statement follows:]

The Heritage Foundation

A tax-exempt public policy research institute

Written Statement of
Edwin J. Feulner, Jr., Ph.D., President of
The Heritage Foundation
214 Massachusetts Avenue, N.E.
Washington, D.C. 20002
As Presented by William J. Lehrfeld

My statement is in response to the invitation by the Subcommittee on Select Revenue Measures, Committee on Ways and Means, to testify on a 501(c)(3) issue set out in Press Release No. 10, August 18, 1993. I wish to offer my personal comments about a proposal involving political activity limits:

> *"(3) A proposal to impose a 30-percent excise tax on expenditures of tax-exempt organizations for lobbying (including amount paid as salaries and an allocable portion of support costs)."*

The Heritage Foundation, as a IRC 501(c)(3) research institution, does not engage in propaganda or otherwise attempt to influence legislation or engage in political campaign activities. We deal in the marketplace of conservative ideas and American ideals. We have no control over what others do to translate our research into concrete legislative proposals nor do we seek to advance or inhibit pending or proposed legislation once it has been introduced.

Saying that is not to say that we are necessarily in complete compliance with existing law. As the members of this Committee know, Section 501(c)(3) of the Internal Revenue Code provides that "no substantial part" of our resources can be devoted to "attempts to influence" legislation. We do not know, nor does the Congress, nor the public, what secret rules the Internal Revenue Service uses to determine what tests are involved in an "attempt to influence" and when advocacy of a legislative topic becomes "substantial". These rules, enacted in 1934, have been a constant source of friction between the IRS and the charitable community.

Many 501(c)(3) organizations operate on the assumption that there is a "safe harbor" expenditure test of five percent of their budget. However, the Internal Revenue Service has refused to say if there is such a "safe harbor," or if its test measures hours of employees time and coordinated volunteer efforts. Similarly missing from the Internal Revenue Service is some form of per se rule which specifies that, for example, an expenditure of twelve percent of the budget will per se justify challenge to the tax exemption.

I believe that the public, and the Congress, would be better served by a repeal of all lobbying limits in 501(c)(3) and its alleged attempt at liberalization, IRC 501(h). Herbert Hoover said that a good many things go around in the dark besides Santa Claus. Congress need not be one of those things. One of the best ways to provide Congress with needed light is to make it as easy as possible for the 501(c)(3) sector to communicate with Members of Congress in as many ways as possible. One of the most efficient, enlightened, informed, and concise ways for the public to communicate with Members is through the charitable organizations which organize and channel the views of their particular constituencies. Today's proposals discount the Congress because it seeks to deprive you of resources for the conduct of your own responsibilities. Some of your own Members would rather have you guess than know of the information and ideas percolating in the public interest.

Someone now proposes to make the already difficult process of legislative advocacy a taxable exercise. In my opinion, a retroactive excise tax on advocacy by charities is unacceptable tax policy and contrary to every principle for accountable government contained in our Constitution. The excise tax proposal seems to spring from the discredited notion that a tax exemption or deductible contribution is some form of financial assistance from government and that as a price for such assistance it can control our Nation's intellectual resources.

The Supreme Court recognized that Congress does not infringe on free speech when it disallows lobbying deductions nor does it deny equal protection to charities when it takes away their tax exemption but not that of veterans groups, when both lobby substantially. (Regan v. Taxation Without Representation of Washington, 461 US 540 (1983)). However safe these precedents are from being overturned, it does not mean that an expenditure tax is safe. Affecting tax exemptions or tax deductions involving excess lobbying is not the same as imposing an actual tariff on lobbying, however defined; an excise tax on lobbying expenditures is an open suppression of Constitutional rights because it taxes the very value of the message sent to your offices. It is, literally, the taxation of ideas. In my opinion, such a tax would not survive a Constitutional challenge; but even so, the real point is not the proposal's constitutional flaws but that Congress should even consider enacting a law which plainly devalues itself and stigmatizes a fundamental freedom. Do you believe that public confidence in its elected representatives would be enhanced by tax policies evidenced this sort of stifling behavior?

In conclusion, Mr. Chairman, if all publicly supported organizations, right, left, and center, are free to participate in shaping public policy, how can the public itself be a loser? Some Members of Congress may feel they have too much to read on too many issues. But I believe you have always benefited from your own conscientious efforts to widen the debate, to give unheard voices a hearing, and to distill from open, unfettered, and even antagonistic comments the best approach to problems and the best avenues to solutions. Surely repeal of the lobbying rules will not automatically accomplish that desirable goal. But it would signal a new openness -- a welcomeness if you will -- to charities, to churches and to educational institutions to assume a rightful role in the legislative arena.

As Thomas Jefferson noted in his first Inaugural Address: "Error of opinion may be tolerated where reason is left free to combat it." Fifty years of fear, ignorance and habits of indifference can perhaps be reversed so that errors of opinion may be fought by institutions of independence, fair partisanship and sensitivity to our national well-being.

September 8, 1993

Mr. HOAGLAND. Ms. Bitter Smith.

STATEMENT OF SUSAN BITTER SMITH, CHAIRMAN, GOVERNMENT AFFAIRS COMMITTEE, AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES, AND EXECUTIVE DIRECTOR, ARIZONA CABLE TELEVISION ASSOCIATION

Ms. BITTER SMITH. Thank you, Mr. Chairman. My name is Susan Bitter Smith. I am the executive director of the Arizona Cable Television Association, the trade association of the cable TV industry in the State of Arizona. I currently serve on the board of directors of the American Society of Association Executives, and as such, chair their government affairs committee.

ASAE is the professional society of over 21,000 association executives representing more than 10,400 national, State, local and trade and professional associations. Most of our members work for associations with less than 10 employees. My organization has a staff of two. However, organizations represented by ASAE include more than 287 million members. These memberships include individuals, businesses, and institutions.

Mr. Chairman, I want to commend you and the subcommittee for providing us an opportunity to testify before Congress on the issue of whether an excise tax of 30 percent should be levied on tax-exempt organizations for expenditures related to lobbying activities. Your generosity is particularly appreciated in light of the very recent and, in our opinion, unfortunate events which resulted in the general loss of association membership dues deductibility related to lobbying expenses.

America's associations oppose an excise tax on lobbying activities and want to restore the dues deductibility related to lobbying expenses. The tax treatment of lobbying expenses already galvanized America's association community. During the recent debate in the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993) thousands of associations and thousands of their members communicated with congressional offices in opposition to this proposal. You will see a partial list of these opponents attached to our written testimony.

When Congress narrowly repealed lobbying expense deductibility in OBRA 1993, it enacted what we believe is an ill-conceived, constitutionally suspect law without the benefit of our input through congressional hearings. So, again, we appreciate the chance to comment on this particular proposal. An excise tax will exacerbate an already bad situation and dialog with Congress on this issue is essential. Many of our 21,000 members, whose organizations represent 287 million members, are upset about the excise tax on lobbying because they see it as an indirect assault on their political rights.

Our members believe that the associations represent them in policy debates.

In addition, they feel shut out of debate on lobbying policy which affects organizations so profoundly. To date, they have not been allowed to demonstrate the important role that associations play in the public policy debate, and they have not had an opportunity to articulate all the positive contributions that associations bring to our country. Use of a tax power to effectively raise the cost of free speech for associations naturally creates a distrust within our membership, especially when they feel the revenues to be gained are so limited, but the potential to thwart political expression and public input of association members is so great.

While the revenue gained from a lobby excise tax may be minimal, the potential for discouraging lobbying activities and public input through the use of a tax mechanism is very great. Since the power to tax is the power to destroy, thousands of associations which represent millions of voting Americans fear Congress will eliminate this important means of communication. As best we can determine, the antilobbying issue became popular in media circles during last year's campaign cycle.

I think there is a misunderstanding of what lobbyists do. We, in fact, expand the public's access to elected officials and do not create a limitation on this necessary part of Government. Many of us like myself do not reside within the beltway nor do we spend money on wining and dining policymakers. Our government relations budgets are spent on information pieces, research, and providing answers to questions posed to us by policymakers.

A recent letter in The New York Times said the Congress should ban lobbying because somehow it is "corrupt." The author of the letter suggested that in place of getting information from industries, professions, associations, and academic sources that Congress should depend with great reliability on its own bureaucracy, the Congressional Research Service. Interestingly enough, the source of much information for the CRS typically is the association community. We provide many, many answers to their questions over time on public policy issues.

ASAE has specific objections to the imposition of an excise tax on lobbying activities. We have seen a lack of evidence and a need to change the current policy. We are particularly disturbed by the tenor of debate over lobbying what appears to many of us, an all out attack on associations and the members we represent. The policies which associations and businesses espouse through lobbying are arrived at in a representative manner. Lobbyists do not speak for themselves. They speak for often a vast number of volunteers, members and other stakeholders.

Association policies are a group of positions. Association policies are developed through representative processes and consensus building. ASAE, for example, derives its policy positions through a careful process of research, analysis and volunteer involvement which ultimately leads to a formal board approval. A lobby excise tax would further stigmatize lobbying activities and impede open communication between citizens and Congress. It would discourage the little guy and create unwieldy administrative burdens which would hit at the main street of our public policy debate.

Anticipated penalties, and the cost of compliance, may cost associations more than the amount of the excise tax raised. Worse than that, any provisions of this nature will contain penalties for noncompliance which could severely discourage the appetite to conduct lobbying activities.

We find it amazing that nobody really knows how many lobbyists there are overall. The number of associations that actually lobby on Capitol Hill number about 2,800 and about 62 percent of them indicate they monitor Federal activities. So it makes no sense to deprive Congress and its staff of the input that associations provide in public policymaking and information to lawmakers, and we regard efforts to discourage lobbying activities as an indirect effort to silence associations on a selective basis.

ASAE would like to take this opportunity to request broader congressional hearings on the role of lobbying in the context of modern politics. Ultimately, we feel the victim of this rush to judgment on taxation of lobbying activities may be the institution of Congress itself.

In conclusion, we would like to remind you that lobbying of the Government should be a tax deductible, necessary and ordinary expense, not subject to an excise tax for five reasons. Lobbying is in the public interest. It is an important, free information flow between Government and citizens. Individuals and associations are forced into a relationship with Government because Government insists that it is our partner in running our businesses, whether we want it or not.

Lobbying is an "ordinary" expense akin to other legal, marketing and communications costs which should be borne as part of doing business. Given the intense degree of Government interest in the workplace, such expenses are at least "ordinary" if not pervasive. Lobbying is advocacy. It is a constitutionally protected right to petition our lawmakers and to make sure that all of us have a say in the way laws are made.

Tax policy should encourage communications between lawmakers and those individuals, groups, and other interests concerned by the legislation. Not only do we oppose this proposal, we respectfully ask for Congress to reconsider the damage which is now ongoing.

We seek repeal provisions of OBRA 1993 which affect association membership dues deductibility related to lobbying expenses. We believe there needs to be more openly debated conversations about this proposal and the proposal that was contained in the Budget Act of 1993.

Mr. Chairman and members of the subcommittee, again on behalf of ASAE, we do want to express our gratitude for allowing this opportunity for input in what is going to be and is a vital issue to our associations and to their members. Thank you very much.

Mr. HOAGLAND. Thank you.

[The prepared statement follows, and an attachment will be retained in committee files:]

WRITTEN TESTIMONY OF
SUSAN BITTER SMITH, CAE
DIRECTOR
AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

before the Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives

Mr. Chairman, my name is Susan Bitter Smith. I am the Executive Director of the Arizona Cable Television Association, the trade association of the cable television industry in Arizona and I currently serve on the Board of Directors of the American Society of Association Executives (ASAE) as well as serve as Chairman of the ASAE Government Affairs Committee.

ASAE is the professional society of over 21,000 associations executives representing more than 10,400 national, state and local trade and professional associations. Most of our members work for associations with less than 10 employees. My organization has a staff of two. However, organizations represented by ASAE include more than 287 million members. These memberships include individuals, businesses, and a diversity of institutions.

INTRODUCTION

Mr. Chairman, we commend you for providing us an opportunity to testify before Congress on the issue of whether an excise tax of 30 percent should be levied on tax-exempt organizations for expenditures related to lobbying activities (including amounts paid as salaries and an allocable portion of support costs). Your generosity is particularly appreciated in light of the very recent, and in our opinion, unfortunate events which resulted in the general loss of association membership dues deductibility related to lobbying expenses.

America's Associations oppose an excise tax on lobbying activities and wants to restore the dues deductibility related to lobbying expenses. The tax treatment of lobbying expenses has already galvanized America's association community. More than 3,000 organizations, a partial list of which is appended, and thousands of additional individuals have already expressed their outrage over loss of business and dues deductibility for lobbying expenses, which occurred only last month in the Omnibus Budget Reconciliation Act of 1993 (OBRA '93). A special ASAE analysis of OBRA '93 is appended to my testimony.

During the recent debate over lobbying tax deductibility, thousands of associations and countless thousands of their members communicated with Congressional offices in opposition to this proposal. When Congress narrowly repealed lobbying expense deductibility in OBRA '93, it enacted an ill-conceived, constitutionally suspect law without the benefit of our input through Congressional hearings.

An excise tax will exacerbate an already bad situation and dialogue with Congress on this issue is essential. We are now certain that an even greater hue and cry will rise from the association community (and many of the 287 million members of organizations represented by ASAE) when they become more fully aware of efforts to impose an excise tax on lobbying activities. This is another reason why we are so appreciative for a chance for dialogue on this important issue.

WHAT IS THE PROBLEM?

Why are so many of our 21,000 members whose organizations represent 287 million members upset about an excise tax on lobbying? They see it as an indirect assault on their political rights. Our members believe that their associations represent them in policy debates.

In addition, associations feel shut out of the debate on lobbying policy which affects their organizations so profoundly. To date, they have not been allowed to demonstrate the important role that associations play in the public policy debate. They have also not had an opportunity to articulate all of the positive contributions that associations bring to our country. A special report on "The Value of Associations to American Society," part of ASAE's Associations Advance America Program, is attached to my testimony.

THE TAX CREATES LITTLE REVENUE - BUT LOTS OF POTENTIAL FOR LIMITING INPUT

Use of the tax power to effectively raise the costs of free speech for associations (30 cents on the dollar) naturally creates discomfort within our membership - especially when they feel that the revenues to be gained are so limited, but the potential to thwart political expression and public input of association members is so great.

ASAE doubts that there is significant revenue in taxing lobbying activities. As we attempt to demonstrate below, only anecdotal data, guesswork, and inflated figures have been used in revenue estimates. Some press accounts of lobbying activity have conveyed a false image of the scope and nature of lobbying activity with Members of Congress as well.

While the revenue gained from a lobby excise tax may be minimal, the potential for discouraging lobbying activities and public input through the use of the tax mechanism is very great. Since "the power to tax is the power to destroy," thousands of associations, which represent millions of voting Americans, fear that Congress will eliminate this important means of communication.

WHAT IS LOBBYING REALLY?

As best we can determine, the entire anti-lobbying issue became popular in media circles during last year's campaign cycle. I think there is a distinct misunderstanding of what lobbyists do. We, in fact, expand the public's access to elected officials, we do not create a limitation on this necessary communication. Many of us, like myself, do not reside within the beltway, nor do we spend money on wining and dining policy makers. Our government relations budgets are spent on information pieces, research, and providing answers to questions posed to us by public policy players.

WHERE SHOULD INFORMATION COME FROM?

A recent letter in the *New York Times* suggested that Congress should ban lobbying because it is somehow "corrupt." The author of the letter suggested that, in place of getting information from industries, professions, unions, academe and other interests, that Congress could depend with great reliability upon its own bureaucracy, the Congressional Research Service (CRS) for information. Interestingly enough, the primary source for CRS statistics is the 100,000 strong association community, which promulgates the lion's share of the technical, marketing, econometric and other research data used by CRS.

David Broder may have hit the nail on the head, when he opined in his *Washington Post* column of April 25,

> "If lobbying were outlawed or severely curbed, who would lose influence - the average small employer who belongs to the Chamber of Commerce or Ross Perot, the famous advocate of lobbying controls? What sort of people do you think hire

> lobbyists: those who already have access to government decisions-makers or those who believe that otherwise they would not have access? My guess is the same as yours. They're the people who fear they would not get their foot in the door without a lobbyist. ...In a world without paid lobbyists access and influence would still exist, but they would be distributed very differently, and the winners, at least in my view, would once again be the elite."

That's where associations fit in. In effect, associations are a key part of Congress' own intelligence system. We perform an auxiliary service to Congress that is provided efficiently and voluntarily. To not understand - and appreciate and encourage - the public benefits which association lobbyists provide to Congress jeopardizes a precious resource of information, research, communications, and accountability. We feel that Congress needs to define what the problem is more succinctly, develop more information on that perceived problem and then consult with the public, associations, and the lobbying community before making arbitrary and dangerous decisions about political "reform."

WHAT ARE ASAE'S SPECIFIC OBJECTIONS TO AN EXCISE TAX ON LOBBYING?

ASAE has specific objections to the imposition of an excise tax on lobbying activities:

1) We have seen a lack of evidence or a demonstrated need to change the current policy. We are particularly disturbed by the tenor of debate over lobbying and what appears to many of us to be an all out assault on associations and the members we represent. Associations represent people and institutions. Buried in the "politically correct" discourse on the "corrupt" nature of lobbying is a mistaken premise - namely that a few individuals who lobby on behalf of associations do not represent the underlying constituencies they speak for.

The policies which associations and business espouse through lobbying are arrived at in a representative manner. Lobbyists do not speak for themselves, they speak for often vast numbers of members, volunteers, and other stakeholders. All interests are "special" and lobbyists are empowered to serve a representative function. We have always been a nation of special interests and are proud of the fact that associations serve to help communicate that function.

If we as lobbyists or spokesmen for our association, err or misinterpret our charge, then we cannot possibly perform our function appropriately. Rest assured, if we fail to perform that function correctly, our job security is limited.

2) Association positions are group positions. Association policies are developed through representative processes and consensus building. ASAE, for example, derives its policy positions through a careful process of research, analysis, and volunteer involvement which ultimately leads to formal Board approval, when and if, consensus is achieved. Countless other associations use similar processes to develop consensus to determine positions and priorities.

About 40 percent of ASAE associations surveyed develop policy recommendations from a government affairs committee or its equivalent in 1992, another 39 percent are governed by the organization's executive committee, and the remainder of associations receive recommendations from a combination of staff and volunteer committees. These structures are democratic and representative in nature. They are more open than many Congressional proceedings. Most of these volunteer-driven committees set term limitations for service - normally a three-year cycle.

3) A lobbying excise tax would further stigmatize lobbying activities and impede open communications between citizens and Congress. It is wrong to tax the expression of political ideas, opinion, and communications on a selective basis. If Congress were to suggest that an excise tax be placed on political speech contained in the *New York Times* or *Washington Post*, we can only imagine the outrage that would occur from the same journalists who criticize Congress and lobbyists. Yet such taxation might be theoretically permissible,

according to recent legal doctrine, so long as it were consistently and fairly applied to all such communications.

In fact, Congress would err in placing an excise tax on opinion contained in association controlled publications and not general media, since the same content would be receiving a beneficial treatment in one case, and be burdened in another. The so-called trade press reports to many millions of Americans. The independent, mass-circulation trade press, including magazines, newsletters, fax sheets, technical bulletins, etc., deserve equal treatment with the big media and newspapers. In fact, there is no difference between their functions. Depending upon how we define "lobbying," it would be virtually impossible for our association-based media to separate out communications to members, analysis of public policy issues, and protected advocacy speech.

4) Taxing lobbying discourages the "little guy" and creates unwieldy administrative burdens. Any proposal which attempts to impose an excise tax for lobbying in fact strikes at "main street" and the little guy. We believe that increasing the cost of lobbying through imposition of a 30 percent excise tax will discourage the marginal players from joining in policy debates - i.e. smaller associations and smaller businesses.

Many association executives have already told us, during the recent dues deductibility battle, that they simply will not get involved in lobbying activities rather than be second-guessed by tax auditors, regulators, and other officials. Such associations have limited access to computer technology, accounting expertise, and general legal and tax assistance. The typical associations affected most by an excise tax include those whose primary missions relate to community service, education, standards-setting, research and technical data sharing. This detrimental effect will doubtless spread throughout the association community at all levels of involvement. Associations can be expected to adopt a "when in doubt, don't" attitude over lobbying and providing public input to Congress.

Keeping double books and requiring excessive record-keeping activities will also stifle lobbying. In fact, compliance costs for the private sector will probably exceed the entire amount of revenue raised by the government.

The added accounting burden implicit in any such proposal is tremendous disincentive to lobby as well. Imagine what it will cost an organization like mine to set up a separate set of accounting books, reporting procedures, and compliance mechanism to pay this excise tax. New computer modifications, more accounting hours, more reports and paperwork, added time - it all adds up to lots of money, which many smaller organizations simply cannot afford.

Lack of consistent financial reporting between related organizations will be a major impediment. For nationally-based organizations, there is great disparity in fiscal year reporting between component organizations. There is frequently great difficulty in standardizing reporting data between related entities. Few organizations harmonize their fiscal years. Many national organizations can contain as many as several thousand chapters or branches. A small majority (52 percent) even begin their fiscal year in January, according to the *Policies and Procedures in Association Management 1992,* a biennial study conducted by ASAE.

Anticipated penalties, and the cost of compliance, may cost associations more than the amount of the excise tax raised. Worse, any provision of this nature would contain penalties for noncompliance, however inadvertent the noncompliance, which could severely discourage the appetite to conduct lobbying activities.

The recent lobbying deductibility provisions initially contained a penalty of $50 per individual member for even the most innocent of reporting mistakes - a prospect which would have bankrupted many organizations, some of which have hundreds of thousands of members. Fortunately, the Conference Committee struck this particular provision in the final hours of debate on the budget package.

5) There will be a negative impact on the ability of associations to attract and retain members - especially in today's difficult economic climate. I have serious doubts that associations can afford to pay a 30 percent excise tax on lobbying. In general, the nonprofit sector has been forced through the same type of consolidations and productivity crisis as for-profit businesses. In fact, some of our current financial challenges stem from a downturn in public funding and a concomitant increase in non-dues sources of revenue generation. In order to survive, many of our associations have had to become more creative, offer unique services and run themselves like any other business.

In a sample of 780 associations, about $2 billion was spent on all economic activities. The average expenditure for Government Affairs activities by all associations amounted to only 4.5 percent. Surprisingly, 75 percent of those associations surveyed reported no expenditures in this category. A total of $70,507,425 was spent by the sampling overall. About $673,966,294 was raised from membership dues by so-called regular members, an additional $36,610,552 by Associate members, and $44,532,976 by other categories of membership.

Generally, membership dues averaged about 42 percent of the typical association's income budget. Interestingly, our figures indicate that regional, state and local membership organizations spend slightly more on government affairs (6.1 percent) than do national groups (4.8 percent). "Lobbying" activities constitute a much smaller percentage of overall association activities than even the limited budgets for government affairs. Our best estimate is that only about one-third of the 4.5 percent (i.e. 0.0145 percent of total budget) of all association government affairs activities could be construed as "lobbying," even under the expanded definition of that term which was adopted by Congress last month.

In fact, data like this leads us to question the validity of the Congressional Budget Office revenue estimates on this topic. Nobody seems to have valid data on lobbying activities and it would seem ill-advised to propose sweeping policies without such basic information.

HOW MANY ASSOCIATION LOBBYISTS ARE THERE?

We can try to estimate. According to ASAE's *Policies and Procedures in Association Management 1992*, 32 percent of association employ government relations staff. Local associations and international associations are the least likely to support a government relations staff, and state/regional associations are the most likely. On average, those associations involved in government affairs employ three government relations staffers.

More than one-third of associations employ registered lobbyists as staff (about the same percent as in 1987) with local associations and international associations the least likely to have them. The average number of staff lobbyists registered at the state and local levels remained at two people between 1987 and 1992, but the average number registered at the federal level actually dropped to two, from three in 1987.

The number of associations lobbying on Capitol Hill may be as many as 2,800. About 62 percent of the sample responded that they monitor federal legislation, but only 38 percent reported that they had one or more lobbying individuals on staff. This figure doubtless understates the actual scope of association-based lobbying activity. For example, associations participate in a number of coalitions, which is more cost effective and representative way of communicating their messages. Associations often may also be involved in lobbying through outside law firms and legislative specialists. Then too, much of the lobbying activity in the state capitals and locally is also conducted by associations and/or their chapters, affiliates, etc.

IF NOBODY KNOWS HOW MANY LOBBYISTS THERE ARE, HOW CAN YOU GENERATE REVENUE ESTIMATES?

We find it quite amazing that nobody knows how many lobbyists there actually are overall. Our best estimate, based upon registrations with Congress, the *Directory of Washington Lobbyists, Lawyers and Interest Groups*, the annual compendium *Washington*

Representatives, and other sources is between 17,000 and 18,000. This does not include certain attorneys who may claim an attorney-client privilege and refuse disclosure, nor some registered foreign agents, nor the many lobbyists operating at the state level. Obviously, a much smaller number actually participate in direct lobbying activities.

ASAE wants Congress to develop better data about lobbying before it devises more ill-conceived legislation. ASAE believes that for every dollar Congress appropriates to the public till, a given number of association-sponsored programs will be damaged, including key community service, technical standard-setting, self-regulatory, research, and educational programs managed by associations.

In addition, ASAE is in the process of analyzing the Constitutional issues raised by the theoretical imposition of an excise tax on lobbying. Intrusion into Constitutionally protected political speech and the right to petition Congress clearly is an issue here. In a nutshell, ASAE's preliminary thought on the matter is that an excise tax on lobbying may be constitutionally deficient for the following reasons:

1) Any Congressional action to withdraw a benefit, such as favorable tax treatment of lobbying, may operate as a penalty on speech and thus involve the First Amendment;

2) The Supreme Court has on various occasions analyzed the loss of a tax benefit as a penalty; and

3) Any Congressional scheme which uses the content of speech or the identity of the speaker (associations, lobbyists) to discriminate between those entitled to a benefit and those who are not entitled to the benefit may also burden speech.

ASAE will rigorously analyze any violation of association First Amendment Rights and will defend its members' interests.

DISCOURAGING LOBBYING IS BAD IDEA AND HINDERS CONGRESS AS WELL

It makes no sense to deprive Members of Congress and their staff from essential information about our profession or industries. Congress and the Executive Branch don't make bad laws and unworkable regulations on purpose. Flawed policy normally results from a failure to understand the consequences of well-intentioned acts.

Associations must have a role in providing information to lawmakers. We regard efforts to discourage lobbying activities as an indirect effort to silence associations on a selective basis. This proposal, although not clearly articulated, presents other problems as well. Consider the following:

1) To the extent that the moneyed or otherwise powerful interests in our society wish to communicate to Congress, cost is a minor consideration.

2) Businesses can easily pass on increased costs for lobbying through the price mechanism - either directly or indirectly.

3) In many states, union membership is compulsory, and therefore dues increases can be absorbed without much protest by members.

4) Associations, on the other hand, have much more difficulty in passing along such cost increases, especially given the economic conditions, competition, and down-sizing occurring in the non-profit world.

WHERE DOES THE MONEY GO?

Mr. Chairman, an important issue that needs to be addressed is what Congress will do with the revenue raised from the proposed excise tax on lobbying. As I mentioned earlier, OBRA

'93 eliminated the deduction for lobbying expenses. The American people were told that the revenue raised from that bill would go toward deficit reduction.

Even before OBRA '93 was enacted, however, the Senate had already passed legislation creating public financing of Congressional elections, which ASAE, most associations, and an overwhelming majority of the American electorate oppose. Because the Federal Election Commission is running a massive deficit for the Presidential Campaign fund, the check off for individual tax returns was quietly raised from $1 to $3.

Earlier this year, the Senate leadership said that the money for public financing of their campaigns would be paid for from revenue raised by eliminating the deductibility of lobbying expenses. While it is unclear where the revenue will go for this new lobbying excise tax, in the Senate's eyes the revenue raised by the lobbying deduction loss was spent even before it was raised and it was not going toward deficit reduction.1

In a nutshell, Mr. Chairman, what we are talking about is taxing the American people's First Amendment rights to provide, as some political pundits have put it "food stamps for politicians." ASAE does not believe this is a wise or politically supportable position.

ASAE would like to take this opportunity to request broader Congressional hearings on the role of lobbying in the context of modern politics. Ultimately, we feel that the greatest victim of this "rush to judgement" on taxation of lobbying activities may be the institution of Congress itself. Congress may have unwittingly blinded itself by impeding the free flow of information and data which is essential to the formation of sound legislation.

CONCLUSION

Lobbying the government should be a tax-deductible "necessary and ordinary" expense, not subject to an excise tax for five reasons:

1) Lobbying is in the public interest. Lobbying is important for information flow between government and citizens. Congress needs to encourage such activities;

2) Individuals and associations are forced into a relationship with government because government insists that it is our partner in running our businesses, our industries, and our professions - whether we want it or not;

3) Lobbying is an "ordinary" expense, akin to other legal, marketing and communications costs which should be borne as a part of doing business. Given the intense degree of government interest in the work place, such expenses are at least "ordinary" if not pervasive. In fact, scrutiny of the Congressional debate which resulted in lobbying expense tax deductibility in the early 1960s demonstrates that Congress considered such factors in the first place. If anything, the same factors which drove Congress to grant deductions in 1962, including the growth and intrusiveness of government at all levels, are even more pronounced today than they were 30 years ago.

4) Lobbying is advocacy. It is a constitutionally protected right to petition our lawmakers and to make sure that all interests have a say in the way laws are made, not just society's elites.

5) Tax policy should encourage communications between lawmakers and those individuals, groups, and other interests which are affected by legislation. ASAE's members manage organizations with more than 287 million members. These are only some of the individuals, businesses, and other organizations which are represented by lobbyists. Lobbying means our right to tell our own story to lawmakers.

Mr. Chairman, this proposal is not only egregious, it needs to be more openly debated by a broader spectrum of people and institutions affected. We also urge Congress to reconsider the original proposal to eliminate dues deductibility. This should be challenged as equally problematic to cherished ideals of pluralism.

Not only do we oppose this proposal we respectfully ask for Congress to reconsider the damage which is now ongoing. We seek repeal of the provisions of OBRA '93 which affect association membership dues deductibility related to lobbying expenses.

Mr. Chairman, again on behalf of ASAE, we want to express our gratitude for allowing us this first opportunity for input on what is a vital issue to associations and their members.

Mr. HOAGLAND. Mr. Gill.

STATEMENT OF CHARLES B. GILL, GOVERNOR AND CHIEF EXECUTIVE OFFICER, NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORP., HERNDON, VA.

Mr. GILL. Thank you, Mr. Chairman. My name is Chuck Gill. I am Governor and chief executive officer of the National Rural Utilities Cooperative Finance Corp., commonly known as CFC. On behalf of our 1,000 cooperatives and public power district members, I appreciate the opportunity to appear before you today.

My oral statement summarizes my testimony, and I would appreciate my full statement to be made part of the record. I am appearing before you today to seek a clarification in the potential legislation that will affect the operation of 501(c)(4) organizations. The National Rural Electric Cooperative Association and their members, which are also members of CFC, strongly support this testimony. It is my understanding Executive Vice President Bob Bergland will be submitting a separate written statement for the record.

CFC was incorporated as a private, not-for-profit cooperative association under the laws of the District of Columbia in 1969. The principal purpose of CFC is to provide its members with a source of financing to supplement the loan programs of the Rural Electrification Administration of the United States Department of Agriculture.

The REA requires that cooperatives receive up to 30 percent of their capital from private sources. CFC is specifically recognized in the Rural Electrification Act of 1936 as amended. CFC's rural members provide service to about 70 percent of the land mass of the United States, serving an estimated 29 million ultimate users of electricity.

CFC can be described in many ways. It is a not-for-profit financing institution whose operations are focused solely on meeting the unique needs of its rural utility systems. It is a member-owned, member-controlled organization. All of the benefits of CFC operation are specifically returned to its members.

Potential legislation affecting 501(c)(4) organizations could have a severe negative impact on CFC's operations. In response to alleged abuses that were committed by some 501(c)(4) organizations which are unrelated in purpose or structure to that of CFC, Representative Pete Stark introduced legislation last year that would prohibit these corporations from allowing any part of their net earnings to benefit any shareholder or individual. His bill entitled, "Application of Private Inurement Rule to Tax Exempt Civic Associations," was part of H.R. 11, the 1992 tax bill vetoed by President Bush.

CFC is concerned that applying private inurement rules under section 501(c)(4) would severely hamper its allocation and retirement of capital credits, thus adversely affecting CFC's ability to operate as a cooperative and maintain its role as a social welfare organization. CFC is not an organization which is abusing its 501(c)(4) tax exempt status.

Applying private inurement provisions to 501(c)(4) without recognition and clarification of CFC's unique situation would force

CFC into a massive financial restructuring to retain its longstanding, unchallenged tax exemption when the intent, we do not believe, was not to affect an organization like CFC.

At CFC's request the IRS reaffirmed CFC's tax exempt status in 1987. The IRS indicated, and I quote,

> "CFC would also help relieve the increasing fiscal pressures on several Federal programs and agencies, thereby contributing to lessening the burden of the Government. Based on the above facts, we respectfully rule that your tax exempt status under section 501(c)(4) of the code will not be adversely affected."

It has been suggested that an alternative form of organization under subchapter T rules would allow CFC to continue its present operations. However, due to its unique structure, it is possible that CFC would incur a new and severe tax liability. The new tax obligation would be incurred because, number one, CFC must retain some of its earnings to pay interest on its subordinated debt which was contributed by our member cooperatives and public power districts; and, two as a prudent lender CFC must make provisions for potential loan and guarantee losses, yet these would not be deductible unless the loss was realized.

When considered on the basis of impact on the rural cooperative and PPD members of CFC, the financial impact is quite negative. Nationwide a conservative estimate would indicate an annual cost increase of $13 to $20 million. These costs would be borne by the ultimate consumers of the nonprofit utilities which serve the rural areas.

Some 70 percent of the rural electric cooperatives currently have rates higher than neighboring utilities. CFC is sympathetic to the concerns expressed by Representative Stark regarding the abuses by some 501(c)(4) organizations which have resulted in unjustified benefits to individuals. However, language outlining the private inurement amendments proposed by Representative Stark would have the net effect of inadvertently restricting the ability of CFC to return benefits of its operations to its members, all of which are not-for-profit organizations, not individuals.

We have researched the Tax Code and developed a suggested alternative which would allow Representative Stark to keep the original intent of his bill intact while allowing CFC to continue to serve the needs of rural America. We would gladly share this with the committee if desired. It is important to keep in mind no Federal dollars are used to support CFC, and our proposal will not cost the Treasury any funds. Our simple request is to allow us to continue to operate as we have done for the past 25 years. It is unfortunate that through no fault of our own that we are caught in the legislative crossfire. We ask for the subcommittee's support in curbing abuses by 501(c)(4) organizations while allowing CFC to continue its present operations.

We thank you for allowing us to present this testimony and obviously we would be glad to answer any questions you might have.

Mr. HOAGLAND. Thank you, Mr. Gill.

[The prepared statement and attachments of Mr. Gill and the statement for the record of Bob Bergland follow:]

STATEMENT OF CHARLES B. GILL, GOVERNOR AND CHIEF EXECUTIVE OFFICER, NATIONAL RURAL UTILITIES COOPERATIVE FINANCE CORPORATION

Good afternoon, Mr. Chairman and Members of the Subcommittee, my name is Chuck Gill and I am Governor and Chief Executive Officer of the National Rural Utilities Cooperative Finance Corporation, commonly referred to as CFC. On behalf of the 1000 members I appreciate the opportunity to appear before you today.

I am appearing before you today to seek a clarification in potential legislation that will affect the operations of 501(c)(4) organizations.

The National Rural Electric Cooperative Association (NRECA) and their members most of whom are members of CFC strongly supports this testimony. It is my understanding Bob Bergland, Executive Vice President of the National Rural Electric Cooperative Association will be submitting a separate written statement for the record.

Background

It would perhaps be helpful to Members of the Subcommittee to give some background on CFC. We opened our doors in 1969, after leaders in the rural electric program felt it was important to develop an additional source of private market financing to supplement the Rural Electrification Administration (REA), an agency within the U.S. Department of Agriculture, loan program for the growing capital needs of America's rural electric cooperatives (RECs).

MISSION STATEMENT

Our mission is a simple one:

CFC is a not-for-profit cooperative whose mission is to provide its member utility systems, through their unified, collective strength, an assured source of low-cost private capital and state of the art financial services.

CFC's role is:

- To provide rural electric distribution systems with an assured source of capital at the lowest possible cost at whatever level is required;
- To provide rural electric power supply systems an assured source of capital and where possible, add economic value to market entry by power supply systems;
- To provide resources, as required, to meet the evolving needs of the rural electric program for capital and financial services;
- To operate and maintain CFC in a manner that will foster and develop cooperative principles of organization and philosophy;
- To foster and support the maintenance and strengthening of the common goals and unity of purpose of the rural electric program; and
- To foster, develop and protect the cooperative form of organization in the utility sector.

CFC - PROVIDING SUPPLEMENTAL CAPITAL TO RURAL AMERICA

National Rural Utilities Cooperative Finance Corporation ("CFC") was incorporated as a private, not-for-profit cooperative association under the laws of the District of Columbia in April 1969. The principal purpose of CFC is to provide its members with a source of financing to supplement the loan program of the Rural Electrification Administration ("REA") of the United States Department of Agriculture.

CFC, headquartered in Herndon, Virginia, makes loans primarily to its rural utility system members to enable them to acquire, construct and operate electric distribution, generation, transmission and related facilities. Most CFC long-term loans to Utility Members have been made in conjunction with concurrent loans from REA and are secured equally and ratably with REA's loans by a single mortgage. CFC also provides guarantees for tax-exempt financing of pollution control facilities and other properties constructed or acquired by its members, and, in addition, provides guarantees of taxable debt in connection with certain lease and other transactions of its members.

History

A significant gap developed in the mid 1960's between the money available for REA loans and the actual needs of the program. It had become apparent that some alternative source of capital would have to be found if the rural electric cooperatives were to meet their service obligation to their rural patrons.

Through the efforts of the National Rural Electric Cooperative Association, the national trade association representing rural cooperatives, a 26-member Long-Range Study Committee of program leaders was appointed to make an in-depth study of future financing needs and to formulate rural electric viewpoints and objectives.

Attempts to interest traditional lenders in providing capital to supplement REA funds were rebuffed. As a result, the rural electric systems themselves determined that the only reasonable method to assure the availability of capital and relieve some of the pressure on government loan programs was to form their own organization to meet their needs.

In March 1969, the Final Report and Recommendations of the Long-Range Study Committee was presented to and approved by the rural electric systems. Essentially, this report called for the establishment of a supplemental financing program to be coordinated through an independent, cooperative institution; and provided that this institution should be financed through the resources of its member-systems.

In July 1970, an "Invitation to Subscribe to Capital Term Certificates" was mailed to all rural electric systems in order to establish the new finance cooperative. By accepting the "Invitation", the rural electrics agreed to capitalize their own supplemental finance organization through the investment of their own funds and without government assistance. CFC was launched on its way toward becoming a full-service, supplemental financing institution for the nation's rural electric cooperatives.

CFC Today

CFC's 1,029 members as of May 31, 1993, included 894 rural electric Utility Members, virtually all of which are consumer-owned cooperatives, 72 service members and 63 associate members. The Utility Members included 830 distribution systems and 64 generation and transmission systems operating in 46 states and U.S. territories. At December 31, 1992, CFC's member rural electric systems provided service to about 70% of the contiguous continental land territory of the United States, serving approximately 12.2 million consumers representing an estimated 28.8 million ultimate users of electricity and owned approximately $60.8 billion in total utility plant.

To assist yet another element of rural America which has traditionally financed its operations through the REA loan program, the Rural Telephone Finance Cooperative ("RTFC") was incorporated as a private, not-for-profit cooperative association in the state of South Dakota in September 1987. RTFC is a controlled affiliate of CFC (six of its eleven directors are appointed by CFC) and was created for the purpose of providing financing to its rural telecommunication members and affiliates. CFC is the sole source of funding for RTFC.

Guaranty Funding Cooperative was organized in December 1991 as a private, not-for-profit cooperative owned by its member rural electric systems and CFC to provide a source of funds for members to refinance their debt to the Federal Financing Bank of the United States Treasury. GFC is a controlled affiliate of CFC.

CFC's primary objective as a cooperative is to provide its members with the lowest possible loan and guarantee rates. Therefore, CFC marks up its funding costs only to the extent necessary to cover its operating expenses and a provision for loan and guarantee losses and to provide for margins sufficient to preserve interest coverage in light of CFC's financing objectives. To the extent members contribute to CFC's base capital with subordinated certificates carrying below-market interest rates, CFC can offer proportionally lower interest rates on its loans to members.

CFC can be described in many ways. It is a private, not-for-profit cooperative. It is an independent financing institution whose operations are focused solely on meeting the unique needs of its rural utility systems. It is a member-owned, member-controlled organization. All of the benefits of CFC's operations are specifically returned to its borrowers. Any margins remaining after all operating expenses are paid are returned to its members on a patronage basis. Most importantly, CFC has played a vital role as the primary supplemental lender to the government loan programs offered by the Rural Electrification Administration. In brief, it is a cooperative organization in every sense of the word, organized and controlled by its member-systems to meet a need that was previously not being met.

CFC - A SOCIAL WELFARE ORGANIZATION

CFC has played a key role in the construction, maintenance, and operation of electric and telephone utility infrastructure in the sparsely populated areas of rural America. By relieving some pressure on federally-funded loan programs, CFC has functioned as the vehicle for providing public market access by consolidating the needs of rural utility systems which would otherwise be too small to efficiently access the market individually.

CFC is specifically identified in the Rural Electrification Act of 1936, as amended, as a legally organized lending institution. The vast majority of CFC's direct loans are secured under a single common mortgage with the Rural Electrification Administration.

CFC's TAX EXEMPT STATUS

CFC's role as a social welfare organization has been recognized since inception by the Internal Revenue Service and as such CFC has remained exempt from Federal income taxes under IRC Section 501(c)(4).

> *Section 501(c)(4) of the Code provides for the exemption of civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.*
>
> *Section 1.501(c)(4)-1(a)(2) of the Income Tax Regulations provides that an organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated primarily for the purpose of bringing about civic betterment and social improvements.*

In fact, CFC's tax-exempt status under 501(c)(4) was first set forth in a ruling dated October 30, 1969. The ruling was most recently confirmed in 1987 when CFC first considered extending the benefits of its not-for-profit service to telephone organizations and their affiliates. In general, the Internal Revenue Service noted that CFC met its social welfare test by lending support and helping to relieve the increasing fiscal pressures on federal programs and agencies thereby contributing to lessening the burden of the government. CFC's mission remains unchanged today.

Legislation Threatens CFC's Operations

Potential legislation affecting 501(c)(4) organizations could have a severe negative impact on CFC's operations. In response to alleged abuses that were committed by some 501(c)(4) organizations (unrelated in purpose or structure to that of CFC), Rep. Pete Stark (D-CA) introduced legislation that would prohibit these corporations from allowing any part of their net earnings to benefit any shareholder or individual. His bill, entitled Application of Private Inurement Rule to Tax-Exempt Civic Leagues, was part of H.R. 11 (the 1992 tax bill vetoed by President Bush).

CFC By-laws

CFC was incorporated under the District of Columbia Cooperative Association Act. Its by-laws (which set out matters required by the enabling act) specify that it shall at all times be operated on a cooperative nonprofit basis for the primary and mutual benefit of its patrons.

> *All net savings, representing the excess of revenues over operating costs and expenses, shall be received by the Association with the understanding that they are furnished by its patrons as capital and that the Association is obligated to pay by credits to a capital account and the reserve funds set up in Section 2 of this Article for each patron all such amounts in excess of operating costs and expenses, to patrons in proportion to their patronage.*
>
> *In the event of dissolution of the Association, outstanding Patronage Capital Certificates, if any, or the amount of patronage capital reflected on the books and records of the Association shall be retired without priority on a pro rata basis in accordance with the provisions of Article IX of the Articles of Incorporation. If, at any time prior to dissolution, the Board of Directors shall determine that the financial condition of the Association will not be impaired thereby the capital then credited to patrons' accounts and the Patronage Capital Certificates evidencing same, if any, may be retired in full or in part. After February 11, 1992, the Board of Directors shall determine the method, basis, priority, and order of retirement, if any, for all amounts thereafter furnished as capital.*

Operations

Each year CFC allocates its net margins (operating margin plus nonoperating income) among its members in proportion to interest earned by CFC from such members within various loan pools. These allocations are evidenced by Patronage Capital Certificates which bear no interest or dividends and have no stated maturity. These amounts are available for use in CFC's operations pending their retirement. It is currently CFC's policy to retire Patronage Capital Certificates on a seven-year, or shorter, cycle if permitted by CFC's contractual obligations and to the extent that the Board of Directors in its discretion may determine from time to time that the financial condition of CFC will not be impaired as a result. RTFC's current policy is to retire 25% of the current year's margins within 8½ months of the end of the fiscal year with the remainder to be retired at the discretion of RTFC's Board of Directors. GFC's current policy is to retire 100% of current year's margins shortly after the end of the fiscal year.

Implications

CFC is concerned that applying private inurement rules under section 501(c)(4) would severely hamper its allocation and retirement of capital credits, thus adversely affecting CFC's ability to operate as a cooperative, maintain its role as a social welfare organization and retain its standing in capital markets. CFC is not an organization which is abusing its 501(c)(4) tax-exempt status.

Applying private inurement provisions to IRC 501(c)(4) without recognition and clarification of CFC's unique situation would force CFC into a massive financial restructuring to comply with cooperative tax law and to retain its long-standing, unchallenged tax exemption when the intent was not to affect an organization like CFC.

POSSIBLE ALTERNATIVES

Subchapter T

It has been suggested that CFC pursue incorporating under Subchapter T rules. That alternative has been thoroughly investigated. In general, however, while some organizations of a like nature find Subchapter T to be an acceptable fit, CFC's unique structure, which was established when CFC obtained its tax-exempt status, does not fit well with the specifications of the rule.

Interest paid on CFC's capital term certificates which provide the underlying equity of CFC might not be deductible for income tax purposes. Therefore, CFC would have to pay that interest out of retained earnings. However, under Subchapter T, the IRS requires that if tax margins are allocated to the membership of a cooperative, a demonstration must be made that those allocations can actually be paid. CFC would not be able to allocate all of its earnings to the members to get a full patronage capital deduction, because some portion of the retained earnings would have already been obligated to pay interest on the capital term certificates. This might result in a conclusion that CFC could not be in compliance with Subchapter T rules.

Therefore, the amount of interest to be paid to capital term certificate holders would have to be excluded from the patronage capital deduction, in order for CFC to demonstrate that it can actually pay patronage allocations under Subchapter T. Any amount excluded from the patronage capital deduction would then be taxable. However, the amount being excluded is interest on capital term certificates which are deemed to be equity. Under Subchapter T rules, CFC would be asked to pay tax on its underlying capital structure, rather than on margins.

In addition, like any other lending institution, CFC must make provisions for loan and guarantee losses. However, that "book" expense would not be deductible for tax purposes under Subchapter T until an actual loss occurs. As a result, CFC would be taxed on a reserve it hopes never to use.

Negative Effect of Subchapter T organizations on CFC's Operations

Subchapter T tax treatment, because of its deleterious effect on CFC's capital structure is therefore not an option should the potential legislation be enacted. It has been estimated that the negative tax effect of transferring CFC from filing under 501(c)(4) to Subchapter T would involve an additional annual state and federal expense of $18-23 million. This has the effect of diminishing CFC's ability to function as a social welfare organization by increasing the costs on its operations which must be flowed through to its member-borrowers.

Impact on Rural Electric Co-ops

When considered on the basis of impact on the rural utility members of CFC, the financial impact is quite negative. Nationwide, a conservative estimate would indicate an annual cost increase of $13-20 million. As CFC grows, the burden will increase substantially. These costs will be borne by the ultimate consumers of the non-profit utilities which serve the rural areas.

Some 70 percent of the rural electric cooperatives currently have rates higher than neighboring utilities. They have undertaken the arduous task of providing electric service to the most sparsely settled areas of the country, requiring more than two million miles of electric lines to serve three-fourths of the countryside. The co-ops have formed a covenant with REA to assume responsibility for area coverage with this vital infrastructure service in return for favorable REA financing.

In fact the REA program is going through substantial revisions during this Congress. It is expected that the loan subsidy to RECs will be greatly reduced. The appropriation bill that has passed the House calls for a subsidy reduction of 43% in FY 94 from FY 93 figures.

Our fellow electric providers, municipals and Investor-owned Utilities (IOUs) are not receiving any reduction in their federal subsidy.

RECs serve almost 11.9 million people, or 10.7% of the population, but we cover a land mass equal to 75% of the nation. We average 5.5 consumers per mile of line, where as the industry average is 36.

Lending to utilities has become a highly competitive endeavor where basis points can literally make or break a deal. Losing its 501(c)(4) tax-exempt status would clearly make CFC significantly less competitive.

CFC - 501(c)(4) SUGGESTED REVISIONS

CFC is sympathetic to the concerns expressed by Representative Stark regarding the abuses by some 501(c)(4) organizations which have resulted in unjustified benefit to individuals. However, language outlining the private inurement amendments proposed by Rep. Stark would have the net affect of inadvertently restricting the ability of CFC to return benefits of its operation to its members, all of which are not-for-profit organizations, not individuals.

We have searched the Code and developed suggested alternatives which would allow Rep. Stark to keep original intent of his bill intact while allowing CFC to continue to serve the needs of rural America. We will gladly share this with the committee.

Conclusion

CFC was formed to supplement the diminishing resources of the federal government. CFC has been a part of a successful public/private partnership.

It is important to keep in mind no federal dollars are used to support CFC and our proposal will not cost the Treasury any funds.

Our simple request is to allow us to continue to operate as we have done for the past 25 years. It is unfortunate through no fault of our own we are caught in the legislative crossfire. We ask for the subcommittees support in curbing abuses by 501(c)(4) organizations and allow CFC to continue its present operations.

US Treasury Department

Internal Revenue Service
Washington, DC 20224

Date: OCT 30 1969

In reply refer to:
Form M-4279
T:MS:EO:R:1-1RD

National Rural Utilities Cooperative
Finance Corporation
2006 Florida Avenue, N.W.
Washington, D.C. 20009

Gentlemen:

I.R. Code: Section 501(c)(4)
Address Inquiries and File Returns with District Director of Internal Revenue: Baltimore
Accounting Period Ending: June 30

On the basis of your stated purposes and the understanding that your operations will continue as evidenced to date or will conform to those proposed in your ruling application, we have concluded that you are exempt from Federal income tax under the provisions of the Internal Revenue Code section indicated above. Any changes in operations from those described, or in your character or purposes, must be reported immediately to your District Director for consideration of their effect upon your exempt status. You must also report any change in your name or address.

You are not required to file Federal income tax returns so long as you retain an exempt status, unless you are subject to the tax on unrelated business income imposed by section 511 of the Code, in which event you are required to file Form 990-T. You are required to file an information return, Form 990, annually, on or before the 15th day of the fifth month after the close of your annual accounting period indicated above.

You are liable for the taxes imposed under the Federal Insurance Contributions Act (social security taxes); and for the tax imposed under the Federal Unemployment Tax Act if you have four or more individuals in your employ.

Any questions concerning excise, employment or other Federal taxes should be submitted to your District Director.

Your District Director is being advised of this action.

Every exempt organization is required to have an Employer Identification Number, regardless of whether it has any employees. This number should be entered in the designated space on all Federal returns filed and referred to on all correspondence with the Internal Revenue Service. If you do not have such a number, your District Director will take steps to see that one is issued to you at an early date.

Very truly yours,

John R. Barber

Acting Chief, Rulings Section,
Exempt Organizations Branch

Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Person to Contact: Mr. Hardesty

Telephone Number: (202) 566-4754

Refer Reply to: OP:E:EO:R:4

Date: 29 JUL 1987

National Rural Utilities
Cooperative Finance Corporation
1115 30th Street, N.W.
Washington, DC. 20007

Employer Identification Number: 52-0891669
Key District: Baltimore

Dear Sirs:

We have received your request for a ruling, dated March 27, 1987, that your exempt status under section 501(c)(4) of the Internal Revenue Code will not be adversely affected by the creation, start-up funding and operation of a new cooperative association to serve as a supplemental source of financing for the nation's rural telephone and telecommunications systems.

You expect that the new telephone cooperative will qualify for tax treatment as a cooperative pursuant to Subchapter T of the Code, that the amounts paid as patronage dividends by the new telephone cooperative will be deductible by it pursuant to section 1382(b) of the Code and, accordingly, that the new telephone cooperative will incur little or no Federal income tax liability. For this reason, the new telephone cooperative is not applying for its own determination of tax-exempt status at the present time.

You are a nonprofit cooperative association formed on April 10, 1969, and have been determined to be exempt from Federal income tax section 501(c)(4) of the Code. You were formed to meet a perceived need for a nongovernmental source of financing to supplement the rural electric loan program of the Federal government. Your overriding purpose in seeking to meet this financing need was to help in the effort to improve the quality of life in rural America.

As of May 31, 1986, you had 964 members, including 885 rural electric systems, virtually all of which were consumer-owned cooperatives, 72 service members and 7 associate members. The electric system members included 822 distribution systems and 63 generation and transmission ("power supply") systems operating in 46 states. As of December 31, 1985, your member systems were serving approximately 9,500,000 consumers, representing service to an estimated 23,600,000 ultimate users of electricity.

You make loans to your members to enable them to acquire, construct and operate electric distribution, generation, transmission and related facilities. Most of your long-term loans to members are made in conjunction with concurrent loans from the government and are secured equally and ratably with their loans by a single mortgage. You also provide guarantees for tax-exempt financings of pollution control facilities and other properties constructed or acquired by your members, and, in addition, provide guarantees in connection with certain lease transactions of your members.

You believe that the social welfare purpose you have served and the experience you have gained in helping to finance the nation's rural electric systems should be extended to the nation's rural telephone systems and their telecommunications affiliates. The need is for a supplementary source of financing to enable these systems to maintain, enhance and diversify the services which they provide to the rural consumer.

As a supplement to existing government loan programs, the implementation of your proposal to establish a new telephone cooperative you believe would both lessen the burden on government and benefit the consumer by enabling the systems involved to acquire and maintain the physical facilities necessary to provide service to the consumer at affordable rates. In addition, you believe you would be benefitting the rural electric consumers whom you already serve since a large majority of those consumers are also consumers of telephone and telecommunications services.

The new telephone cooperative will be incorporated under the state law which will provide the flexibility required for its efficient operation. As a cooperative operating in a manner similar to you the new telephone cooperative will conduct its lending activities on a break-even basis, setting its lending rates at the lowest level commensurate with sound management and in keeping with non-profit cooperative principals. All "net savings" (that is, the excess of revenues over operting costs and expenses) generated by the cooperative will be allocated among its patrons as patronage capital. Such allocations will have the effect of a proportionate rebate or readjustment of the cost to each patron of its borrowings. The new cooperative will also contribute to the education of its patrons.

The emphasis of the new telephone cooperative's operations will be on achieving financial efficiencies so as to reduce the cost of rural telephone and telecommunications services to the consumer. Much in the manner you do, the new telephone cooperative expects to be able to raise large amounts of capital in the private capital markets to relend to patrons whose individual capital requirements would generally be relatively small and would, thus, require a premium in the market place.

The new telephone cooperative would offer memberships to all of the independent telephone operating companies in the United States which presently are either actively borrowing, or are eligible to borrow, from the government. You would also become a member of the new telephone cooperative.

In order to accomplish its lending purposes as efficiently as possible, the new telephone cooperative expects that its patrons will include not only the telephone operating company members, but also (i) their subsidiaries and sister companies engaged in furnishing telecommunications services to rural consumers and, (ii) where appropriate, the holding companies. Neither the telecommunications affiliates nor the holding companies referred to are, or would be, eligible to borrow from the government since its telephone lending program is limited to telephone operating companies and has not kept pace with modern technological developments. The inclusion of holding companies for such telephone and telecommunications affiliates is intended to give the new telephone cooperative lending flexibility where, for example, regulatory or other business considerations may require that the funds available from the new telephone cooperative be invested or advanced through the holding company rather than directly by it to the operating company, or that the acquisition of another rural telephone or telecommunications company be made by the holding company rather than by the operating company.

It is anticipated that the members and other patrons will look to the new telephone cooperative for long-term loans to finance additions to plant and to replace existing facilities, to refinance existing debt, to develop diversified telecommunications facilities, to establish rural toll networks and to facilitate the acquisition of other rural systems to provide efficiencies of scale. As in your case, the new telephone cooperative's long-term loans to government telephone borrowers will be secured with government loans by a single mortgage whereever applicable.

The new telephone cooperative's equity funds would be derived principally from three sources. First, eligible organizations, as a condition to membership, would make a one time permanent investment in the form of a $1,000 membership fee, to be evidenced by a membership certificate. Second, as a condition to eligibility to borrow, borrowers would be required to purchase equity certificates. Presently, it is contemplated that such certificates would be in the amount of 10% of the face amount of each loan. The new telephone cooperative would retain one-half of the proceeds from the issuance of such certificates for the entire term of the loan but would be obligated to repay the remaining one-half to the borrower periodically, as the loan is amortized. Membership certificates, equity certificates and patronage capital would be subordinate to the claims of creditors. The third source of equity funds would be the "net savings" (patronage capital or margins), allocated as patronage capital to the patrons on the basis of their respective patronage. A portion of patronage capital so allocated to its patrons would be the patronage capital which you allocate to the new telephone cooperative based on its borrowings from you. Although you would lend credit to the new telephone cooperative during its start-up phase, you would not be a patron or a borrower. Hence, you would not receive patronage allocations from the new telephone cooperative or otherwise be entitled to any share of its accumulated equities.

The above-described equity sources will not be sufficient during the new telephone cooperative start-up phase to fund its lending program. Although it is expected and intended that it eventually will be able to sell its own debt securities in the private capital markets without your assistance, additional funding requirements during its start-up phase would be supplied by you, either by loans to it or by guaranteeing borrowings in the private capital markets. In order to qualify for such credit support by you, the new cooperative would become your associate (non-voting) member you would charge the new cooperative an interest rate commensurate with those rates charged your other associate members, such rates set to reflect your non-profit cooperative principles. As in the case of any other of your members, the new cooperative would be required to meet your equity investment requirements in connection with its borrowings from you. The new cooperative would also be charged guarantee fees for your guarantees of the new cooperative's debt similar to those charged your other members which obtain your guarantees.

The members of the new cooperative, including you, would enter into an agreement pursuant to which eleven members (i.e., a majority) of the twenty-one member board of directors would be nominated for election by you, and the remaining ten members of the board would be nominated by the rural telephone system members of the new telephone cooperative. At the annual meeting, the members would, in accordance with the members agreement, elect these nominees.

It is also proposed that the new telephone cooperative would enter into a management agreement with you, pursuant to which you would agree to provide the management services necessary for the day-to-day conduct of its activities. You would be compensated for your administrative and overhead expenses in connection with these services in one of two ways. For each loan made by you, you would charge the same interest rate you charge other associate members on comparable loans, such interest rate to include a factor for your overall administrative and overhead expenses expressed as a percentage of your total loan volume. In addition, to the extent that the amount described above does not adequately compensate you for your administrative and overhead expenses, you would submit, from time to time, invoices setting forth in reasonable detail your expenses for which you have not been compensated, and the new telephone cooperative would, promptly following receipt of any such invoice, pay to you the amount set forth therein.

You have received substantial expressions of interest from the rural telephone and telecommunications community concerning the development of a supplementary source of financing for that community and have received a number of loan applications relating thereto. Because you lend only to your members, you, pending the formation of the new telephone cooperative, have referred these loan applications to one of your members.

Section 501(c)(4) of the Code provides for the exemption of civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare.

Section 1.501(c)(4)-1(a)(2) of the Income Tax Regulations provides that an organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the people of the community. An organization embraced within this section is one which is operated primarily for the purpose of bringing about civic betterment and social improvements.

Organizations primarily engaged in activities defined as charitable under section 1.501(c)(3)-1(d)(2) of the regulations may qualify under section 501(c)(4). The term "charitable" includes relief of the poor and distressed or the under-priviledged, lessening of the burdens of government, combatting community deterioration, and the conservation and preservation of natural resources.

In Rev. Rul. 64-187, 1964-1 C.B. 187, a nonprofit corporation was formed to lend additional funds to individuals and organizations eligible to borrow from the Federal Area Redevelopment Administration. In ruling that the organization was exempt under section 501(c)(4) of the Code it was stated:

> (t)he instant organization, in carrying out is purposes of providing funds through loans to assist in eliminating unemployment in furtherance of the public purposes of the Area Redevelopment Act, is being operated primarily to bring about civic betterment and social improvement. Accordingly, it is held that the organization qualifies for exemption from Federal income tax under section 501(c)(4) of the Code as a civic league.

If a nonprofit organization uses profit-oriented business organizations merely as instruments for the accomplishment of social welfare purposes, incidental private benefits to such businesses will not disqualify the nonprofit organization from exemption. See Rev. Rul. 81-284, 1981-2 C.B. 130; Rev. Rul. 74-587, 1974-2 C.B. 162; Rev. Rul. 67-294, 1967-2 C.B. 193; and Rev. Rul. 64-187, supra. (All four rulings involve organizations formed to make loans to businesses in order to alleviate unemployment and generally promote the economic development of a community.)

In Rev. Rul. 64-187, supra., the nonprofit organization was authorized to make loans to "proprietorships, partnerships, corporations, governmental bodies, public nonprofit corporations and state and local development companies" which met the requirements of the Area Redevelopment Act. In Rev. Rul. 74-587, supra., as amplified by Rev. Rul. 81-284, supra., a nonprofit organization was created to provide financial assistance "in the form of low-cost or long-term loans for the purchase of equity interests" in minority-owned businesses in certain economically depressed areas. In granting section 501(c)(3) tax-exempt status to the organization, the Service held that through its program of financial assistance, the organization is devoting its resources to uses that benefit the community in a way that the law regards as charitable.

The regulations under section 501(c)(4) hold that a social welfare organization will qualify for exemption as a charitable organization if it falls within the definition of charitable set forth in section 501(c)(3)-1(d)(2). The term "charitable" includes "lessening the burdens of government".

In Rev. Rul. 74-361, 1974-2 C.B. 159, a nonprofit organization which provides fire and rescue service to the general community was found to lessen the burdens of government. Although tax exemption was requested and granted under section 501(c)(3) of the Code, the ruling observed that because the activities of this organization may also be regarded as promoting the common good and general welfare of the community, the organization could have applied for and received a ruling recognizing its exemption from Federal income tax as a social welfare organization described in section 501(c)(4) of the Code. See also Rev. Rul. 85-1, 1985-1 C.B. 177, and Rev. Rul. 85-2, 1985-1 C.B. 178.

Your proposal to form the new telephone cooperative is in furtherance of your social welfare purpose and, accordingly, you would continue to be viewed as "not organized or operated for profit" and "operated exclusively for the promotion of social welfare" within the meaning of section 501(c)(4) of the Code. The fact that you, in lending to the new cooperative, and that it, in lending to its patrons, will each provide for the realization of "net savings" (or margins) does not detract from your nonprofit character.

As previously demonstrated herein, you, by lending support to the funding and operation of the new cooperative, would also help relieve the increasing fiscal pressures on several federal program and agencies would thereby contribute to the lessening the burden of the government.

Based on the above facts, we respectfully rule that your tax-exempt status under section 501(c)(4) of the Code will not be adversely affected by the creation, start-up funding and operation of the new telephone cooperative.

A copy of this ruling should be kept in your permanent records.

A copy of this ruling will be forwarded to your key District Director.

Sincerely yours,

Milton Cerny

Milton Cerny
Chief, Exempt Organizations
Rulings Branch

STATEMENT OF BOB BERGLAND, EXECUTIVE VICE PRESIDENT, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION

Mr. Chairman, distinguished members of the Subcommittee, my name is Bob Bergland and I am executive vice president of the National Rural Electric Cooperative Association (NRECA). I submit this statement for the hearing record on behalf of the nation's 1,000 not-for-profit, consumer-owner rural electric systems that provide central station electric service to more than 25 million people in 46 states.

Rural electric lines span 70 percent of the nation's land mass to serve 10 percent of the nation's population. These rural electric systems continue to face the traditional obstacles that make serving rural areas difficult -- rugged terrain, harsh weather and distance.

Another obstacle is rate disparity. Seventy percent of rural electric systems have higher rates than their neighboring utilities. Part of that rate disparity is attributable to the higher per-consumer investment in plant necessary to serve in rural areas. In addition, rural electric systems serve primarily residential loads -- two-thirds residential as compared to two-thirds commercial and industrial loads served by investor-owned and municipally-owned utilities.

Rural electric systems are consumer-owned, and organized as not-for-profit cooperatives. Everyone who receives service is a member-owner of the rural electric system and any revenues that exceed expenses are returned to consumers in the form of capital credits. There is no profit.

The majority of rural electric systems obtain the bulk of their financing in the form of loans from the Rural Electrification Administration (REA), an agency within the U.S. Department of Agriculture. Most cooperatives are required to obtain 30 percent of their capital requirements from private sources at market rates.

This is where National Rural Utilities Cooperative Finance Corporation (CFC) steps in.

Background

Back in the late 1960's, the leaders of NRECA realized the need to develop additional sources of capital to meet the growing needs of rural America.

In 1969, utilizing start up capital provided by the cooperative members themselves, CFC opened its doors. For the past nearly 25 years it has been a reliable source of private funding for rural utility systems and a leading practitioner in maintaining a strong cooperative business philosophy.

Issue

The IRS initially determined that CFC was a 501(c)(4) organization and this ruling was reaffirmed in 1987. As a cooperative, CFC must return any margins exceeding the costs of operations back to the members.

Legislation proposed by Representative Pete Stark would directly prohibit 501(c)(4) corporations from allowing any part of their net earnings to benefit any shareholder or individual.

We are sympathetic to the objectives of Representative Stark, which is to curb the abuses by some 501(c)(4) organizations. CFC is not abusing its tax exempt status and we seek the Subcommittee's support to allow CFC to maintain its current operations.

Alternatives

It has been suggested that CFC could reorganize as a Subchapter T corporation. This idea has been thoroughly researched and it has been determined that the potential cost is between $13-20 million.

This new tax obligation would be incurred because:

1) CFC must retain some of its earnings to pay interest on its subordinated-debt which was contributed by its members; and
2) As a prudent lender, CFC must make provisions for potential loan and guarantee losses, yet these would not be deductible, unless the loss was realized. Something no lender wants to see happen.

This new and severe cost would ultimately be borne by the rural consumers who already on average pay more for their electric service.

We feel that with a relatively minor change we can still curb all the abuses practiced by some 501(c)(4) groups, while preserving CFC's tax-exempt status.

CFC is not dependent on the Federal government. It is a totally private cooperative corporation. This proposal will in no way cost the U.S. Treasury any funds, yet will allow CFC to continue its fine tradition of service to rural America.

I thank the Subcommittee for the opportunity to submit this statement.

Mr. HOAGLAND. Mr. Payne.

Mr. PAYNE. Thank you, Mr. Chairman.

Mr. Gill, I would like just to ask a couple questions because some of your member organizations are rural electrical cooperatives that are in my district, and I have heard from them about this particular subject and this issue. They generally receive a substantial part of their private source funds, the 30 percent that you mentioned, from CFC.

In 1969 when the CFC was established, the IRS ruled that it was clearly in compliance with the law then and it continues to be today. It provides a source of financing that is important to these rural electric co-ops. They have a great deal of difficulty because the homes they serve are far apart. As a result, they have to make large plant investments in order to provide electrical service to each and every home. They are constantly looking at ways that they can be as competitive as possible in a very large marketplace.

Now, it is my understanding that the changes that you proposed to the legislation that Representative Stark has proposed would in no way take away from the intent of his legislation. In other words, what you are doing takes the CFC, but leaves behind the language to deal with the abuses that Pete Stark was attempting to deal with as he wrote this legislation. Am I correct in assuming that?

Mr. GILL. Yes, sir, Congressman. We are sympathetic with Representative Stark's proposal. What we drafted would uniquely apply to CFC only and would not provide any other exemptions for other types of organizations, and obviously the committee could look at that language if they chose and determine that themselves, but we are sympathetic with the purpose of Representative Stark's approach. We are merely attempting to save dollars for our rural electric cooperatives which you mentioned have very low densities and are attempting to save their costs.

Mr. PAYNE. It would seem to me that this is a situation that currently works. It is important for rural areas. The whole subject of the REA is one that has been brought up this year. It has been taken up by the Agriculture Committee which oversees the REA. It has been looked at thoroughly and I am sure will continue to be because of the public policy implications of below-market financing for REAs.

It seems that is a proper forum in which such a review should occur. While it is important that this legislation be enacted to do away with the potential abuses or the existing abuses, the CFC should be taken out. I appreciate you coming here today and sharing this testimony with us.

Mr. GILL. Thank you very much.

Mr. PAYNE. Thank you.

Mr. HOAGLAND. Ms. Beard, now you have pointed out in your testimony that there are two problems with the current tax law provisions. First, a list of prohibited discriminations does not include sex discrimination, and second, the prohibition extends only to official written policy, such as articles and bylaws and not to discriminatory practices. Is that right?

Ms. BEARD. That is correct.

Mr. HOAGLAND. So what do you suggest the committee—what action do you suggest the committee take?

Ms. BEARD. Our suggestion is that the code be expanded to include gender discrimination along with the other discriminations that are currently in the code, and that in addition to written policies that rules, practices, customs also be included in the code, so we are suggesting that those expansions be included.

Mr. HOAGLAND. Has legislation been introduced to that effect?

Ms. BEARD. There was legislation introduced in January 1991. There has been no legislation that we are aware of introduced in this Congress.

Mr. HOAGLAND. All right. Now, if an organization's tax exemption can be denied on the basis of discriminatory practices, do you believe that IRS would be capable of monitoring such behavior?

Ms. BEARD. I certainly believe that that would be difficult. It would occur through audits. It is the practical matter. I certainly don't suggest that they would go out and become the regulatory body of that. As they are now, the discrimination is currently in the code. It just doesn't extend to gender, so we are asking simply that it be the same kind of regulation.

Mr. HOAGLAND. IRS would enforce it presumably by responding to complaints among other——

Ms. BEARD. To complaints or through audits.

Mr. HOAGLAND. Mr. Lehrfeld, now the Heritage Foundation currently enjoys tax exempt status. Is that right?

Mr. LEHRFELD. That is correct, it is under section 501(c)(3).

Mr. HOAGLAND. And the language you have here in your statement, "does not engage in propaganda or otherwise attempt to influence legislation or engage in political campaign activities"; is that one of the preconditions for tax-exempt status?

Mr. LEHRFELD. That is one of the conditions contained in section 501(c)(3).

Mr. HOAGLAND. So if that is violated, presumably your tax-exempt status could be revoked.

Mr. LEHRFELD. If the legislative limitation is exceeded under the substantiality test, revocation is appropriate. That is correct. The political campaign activity limitation has no quantitative floor on it.

Mr. HOAGLAND. On page 2 you quote the language "No substantial part of your resources can be devoted to attempts to influence legislation."

Is that right?

Mr. LEHRFELD. Correct.

Mr. HOAGLAND. I understand you have a budget of about $20 million a year.

Mr. LEHRFELD. I think that is correct.

Mr. HOAGLAND. I am curious as to what the purpose of—I understand that there was an issue bulletin published recently by the Heritage Foundation, "Six Reasons Why Bill Clinton's National Service Program Is a Bad Idea."

I am curious what the purpose of that issue bulletin would be if not to influence legislation.

Mr. LEHRFELD. I have not read that bulletin, but I would say that under existing IRS rulings on the legislation clause, a full and fair presentation, one that permits the reader to make a judgment independent of that advocated, it is not lobbying. It is not regarded as an attempt to influence legislation. If the bulletin is full and fair, it is not an attempt to influence legislation.

If the bulletin is not full and fair, it would be an attempt to influence legislation.

Mr. HOAGLAND. You are giving us a technical interpretation though, right?

Mr. LEHRFELD. As counsel, all I do is give technical interpretations.

Mr. HOAGLAND. Of IRS rulings? So you are telling us that the IRS has previously adopted that position?

Mr. LEHRFELD. Certainly.

Mr. HOAGLAND. Look at this title again, "Six Reasons Why Bill Clinton's National Service Program Is a Bad Idea." The National Service Program is pending legislation here, is it not?

Mr. LEHRFELD. I don't know. I must plead ignorance on that particular piece of legislation. If it is pending or proposed legislation, then it is something that has to be dealt with under the full and fair test.

Mr. HOAGLAND. Can you give me a reason why Heritage Foundation would publish a bulletin called, "Six Reasons Why Bill Clinton's National Service Program Is a Bad Idea" unless it were to influence legislation concerning that?

Mr. LEHRFELD. I suppose it is to alert the members and to alert the public about what is in the bill and one way to do that is to provide a teaser headline. I think if things came to you in a rather dull format, you might not bother to look at it. The text would have to be read to see whether or not it is an attempt to influence legislation.

Mr. HOAGLAND. Let's look at the plain language meaning of attempt to influence legislation and set aside any IRS technical constructions of that language. Surely the plain language understanding of a title like that would be that it is intended to prevent that bill from being considered seriously.

Mr. LEHRFELD. If that is the conclusion you would draw from it, then that is the appropriate conclusion for yourself. I think that the problem is that the lobbying limitation has not been dealt in that fashion. As a consequence, we look at what the IRS has said in published rules. Also important is what has been accepted by the auditors who have done examinations of all the Heritage Foundation materials in three examinations from 1974 forward.

Mr. HOAGLAND. Can you give me a purpose for that piece other than an attempt to influence legislation?

Mr. LEHRFELD. I think the purpose is to give the public information about the proposed legislation. Whether they choose to accept or reject any of the facts that are in there is their choice. Whether they accept or reject Heritage opinions in there is also their choice. Heritage gives them access to all that information.

Mr. HOAGLAND. At the bottom of the front page of that report was the language "Note: Nothing written here is to be construed"—and there is an omission—"as an attempt to aid or hinder the passage of any bill before Congress."

That appeared on the same page that the language "Six Reasons Why Bill Clinton's National Service Program Was a Bad Idea" appeared.

Is that your understanding?

Mr. LEHRFELD. I think that the disclaimer is there because of the belief taken from IRS opinions that if something represents the personal opinion of an individual associated with an institution, it will be regarded as such rather than an institutional point of view.

Mr. HOAGLAND. You don't see any inconsistency between that disclaimer and the title of the piece?

Mr. LEHRFELD. Professionally or personally? I would prefer not to see a disclaimer because if Heritage is going to influence legislation by going beyond the full and fair test, then they should be proud of the piece they put before the public.

But if they choose to limit their efficacy by putting on a disclaimer, I think they have been intimidated by the tax law. In turn, the right of the Congress to know the facts and opinions of others is diminished. Congressmen are the ones who are the losers.

Mr. HOAGLAND. How about the title, "Economist Calls Clinton's Economic Plan Dishonest, Deceptive"? That was from Heritage Foundation News.

What would the purpose of that news item using the word "news"——

Mr. LEHRFELD. I would say it is again to get someone's attention. It is no different I suppose than a fundraising letter in the mail showing a diseased or crippled child and promoted by a charity that is soliciting your financial support. It is an attention getter and if you do read the article and you do absorb the text and find in the text matter there of value to you, that attention getter served its purpose. In making a judgment about whether or not you should pass or deny passage to a piece of legislation, then the public is better served by an attention getter.

These kinds of questions are why the Heritage Foundation opposes any lobbying limits.

Mr. HOAGLAND. But designed to get the attention of who?

Mr. LEHRFELD. Anyone who is interested or who has the same ideology as the Heritage Foundation.

Mr. HOAGLAND. How about this title: "The National Competitiveness Act: A High-Tech Boondoggle." We voted on the National Competitiveness Act just a few months ago.

Mr. LEHRFELD. I have not read any of these bulletins.

Mr. HOAGLAND. Doesn't that sound like an attempt to influence legislation pending before Congress?

Mr. LEHRFELD. Was that matter pending before Congress at the time? Is that the headline? Is it the introduction? Is it the teaser? What is the text of the item?

If you read that piece and you come to a conclusion that was other than the conclusion advocated, then under Internal Revenue laws that is not an attempt to influence legislation.

Mr. HOAGLAND. Do you think the Internal Revenue laws should be amended to make it clear that something that is so obviously an attempt to influence legislation is in fact an attempt to influence legislation?

Mr. LEHRFELD. No. We believe that all the limits on lobbying should be repealed because you are not best served by having the charitable sector suppressed.

Mr. HOAGLAND. What about radio advertisements that are run in communities around the country that seriously distorted the actual effect of the Clinton economic package operated by tax-exempt organizations that claim tax-exempt status?

Mr. LEHRFELD. You may have those same messages by labor unions who do not follow Mr. Clinton. Mis-messengers may be trade associations which are also tax-exempt. They may be social welfare organizations. They may be charities. Tax exemption covers 25 different classifications of organizations.

Mr. HOAGLAND. It is your opinion that their tax-exempt status should not be jeopardized by——

Mr. LEHRFELD. Absolutely not.

Mr. HOAGLAND. Radio and newspaper ads run in congressional districts——

Mr. LEHRFELD. That is the position of the Heritage Foundation, which I subscribe to personally as well.

Mr. HOAGLAND. But by putting out publications with these sorts of inflammatory titles, the Heritage Foundation is certainly pushing the envelope, isn't it, on what is allowable?

Mr. LEHRFELD. Well, I suppose if you had a liberal Democrat over here reading it and you had a conservative Republican over here reading it, you might come to two different conclusions about whether or not it was, but again you have to get to the text and beyond the teaser.

Mr. HOAGLAND. It would have to be a poorly written text if it carried the title "The National Competitiveness Act: A High-Tech Boondoggle," and didn't make the point.

Mr. LEHRFELD. If it did make the point but if you were able to draw a conclusion other than that advocated because of what was in the text, then the point of it is it is not lobbying under how the IRS enforces the lobbying limit today.

Mr. HOAGLAND. When Congress passed the legislation, it prohibited use of tax-exempt funds for institutions that engage in propaganda or otherwise attempt to influence legislation or engage in political campaign activities. Congress provided "no substantial part" of the resources can be devoted to "attempts to influence" legislation.

It seems to me that regardless of Internal Revenue Service rulings and what technical positions the Service may have taken, the Heritage Foundation, in putting out reports of this sort, is flouting the plain meaning of that language.

Mr. LEHRFELD. Let's accept for purpose of this discussion that premise. Then the question becomes how much is substantial. We would like to know that. In our written text, we have questioned why, since 1934, has the Service chosen not to put any kind of a safe harbor into its regulations so that an organization—whether it is the Birth Defects Foundation or the Cancer Society or Johns Hopkins University—what the safe harbor is for allowable lobbying. Nor is there a ceiling that says "If you go beyond this, you have gone too far."

Mr. HOAGLAND. It sounds like you think this whole area of the law should be reviewed?

Mr. LEHRFELD. Absolutely.

Mr. HOAGLAND. What is your opinion on whether organizations that go into the field, go into congressional districts, take a piece of pending legislation, grossly distort the provisions and the effects of that legislation in radio and newspaper ads? They should be allowed to claim tax-exempt status?

Mr. LEHRFELD. I don't think anyone can condone educational activity which is based on lies, or any kind of activity which is a distortion of facts. But the tax laws are not enacted to control that type of behavior. We are dealing with tax laws that are meant to in part provide assistance to nonprofit organizations generally, whether they are farmers co-ops or charities or social clubs, because of the general activity they do. If you have illegal activity, that can be remedied; if you have other sorts of improper activities, that can be remedied. But distortion of the truth is too subjective; putting truth controls into the hands of an auditing agent——

Mr. HOAGLAND. We can never make illegal distortions. The First Amendment protects wrong statements as much as correct statements, but I think what we can do is deny tax-exempt status to activities that we don't think merit it.

Mr. LEHRFELD. The provision was enacted in 1934 by a group of Senators who found that an organization called the National Economy League was fighting President Roosevelt over some of his New Deal proposals. That type of behavior of intimidation by Members of Congress continues. You get letters going to the Internal Revenue Service from Members who want to take away the tax-exempt status of any number of different organizations because they are making them uncomfortable in the ideas that they propagate. It is not helpful to the tax-exempt sector to have that type of intimidation.

Mr. HOAGLAND. Does it surprise you that if the law provides that no substantial part of an organization's resources can be devoted to attempts to influence legislation and reports are published by the Heritage Foundation with these kinds of titles—here is another one. "Heritage Foundation Backgrounder: Advantage Incumbents: Clinton's Campaign Plan Proposal."

Does it surprise you that with those kinds of titles people aren't going to send letters to the IRS complaining?

Mr. LEHRFELD. I am not concerned about people sending letters. I am concerned about the effect on officials of the United States, Members of Congress who would attempt to use their position of power to intimidate the public sector into following the beliefs that they happen to have. I am not concerned about the general public.

Mr. HOAGLAND. These titles appear to me to flout the plain language of the statute.

Mr. LEHRFELD. Whatever the titles are, I think the audit process—and the Foundation has been through the audit process three times—they have survived challenges that have been brought and the IRS is the best judge of what the law is.

Mr. HOAGLAND. Thank you.

It does not surprise me you have been audited three times as I see this material.

Mr. Gill, one final comment with respect to your testimony. Let me associate myself with the comments made by Mr. Payne. That certainly reflects my view as well.

As you know, most of our electric power in Nebraska is sold through public power districts. We are the only public power State, one of George Norris' great reforms that we still benefit from. I know that the individual public power districts raise capital through the tax-exempt bond market.

Does CSC play a role in Nebraska?

Mr. GILL. We have played a role in Nebraska in that respect. Like most cooperatives in public power districts, they are too small to enter the market individually. We have used our credit strength to guarantee the tax-exempt bonds of the public power districts, thereby enhancing their entry into the market and lower cost.

Mr. HOAGLAND. Ms. Bitter Smith, as you a know, a provision in the recently enacted budget reconciliation bill disallows a business deduction for trade association dues that are allocable to lobbying. The current proposal would make all exempt organizations, whether or not they have business members, subject to a flat 30 percent excise tax on their lobbying expenditures.

In your view, which of the two provisions is fairer and which is more administrable?

Ms. BITTER SMITH. Mr. Chairman, bear in mind the existing provision that was enacted in the Budget Act implicates only 501(c)(6)s, of which my association happens to be categorically. These proposed provisions which could reach across the board to 501(c)(3)s, 501(c)(4)s, 501(c)(6)s and 501(c)(7)s.

On the surface it may appear to be fair, but let me remind you that in fact what will happen is all those organizations will now be impacted into providing information and communication to you as a Member of Congress.

The C–6 community will be hit doubly. Not only will they not be allowed to deduct their dues, but on top of that, they will be hit with a 30 percent excise tax. ASAE's position is that neither provision is palatable and appropriate and certainly this provision of the excise tax should not be enacted.

We encourage you to go back and relook at the provision that was recently passed as it impacts this deductibility issue.

Mr. HOAGLAND. Would it help you to have an excise tax as a option, as an alternative?

Ms. BITTER SMITH. There is an option that currently exists for the association to pay the tax directly, a proxy tax, as opposed to the dues deduction. Both are problematic and difficult to calculate.

I don't know that our members know which is better, yet they both believe that they are both problematic in terms of calculating what is appropriate and what isn't and how to sell that to our members.

I think we would urge you that both concepts are faulty.

Mr. HOAGLAND. Thank you.

There being no further testimony, thank you for coming and the hearing is adjourned.

[Whereupon, at 4:35 p.m., the hearing was adjourned, to reconvene on Tuesday, September 21, 1993, at 10 a.m.]

MISCELLANEOUS REVENUE ISSUES

TUESDAY, SEPTEMBER 21, 1993

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:10 a.m., in room 1100, Longworth House Office Building, Hon. Michael R. McNulty presiding.

Mr. McNulty. Good morning.

Today the Subcommittee on Select Revenue Measures is continuing its hearings on miscellaneous revenue issues. Chairman Rangel has been called away to attend to another matter, but he will be joining us later. The chairman has asked that the subcommittee begin promptly, since some of the invited witnesses have time constraints.

Today the subcommittee will receive testimony from three of our colleagues: Representatives Gerald Kleczka of Wisconsin; Tom Lantos of California; and Alan Wheat of Missouri. We will also hear from the Department of the Treasury and the U.S. General Accounting Office.

The testimony of the Treasury Department will cover all the revenue-raising proposals that were set forth in subcommittee press releases No. 9 and No. 10. In addition, we will hear from several business associations and corporations.

The focus of today's hearing will be on revenue-raising proposals in the areas of foreign taxation, classification of workers, compliance, tax-exempt entities, and some excise tax issues. The subcommittee anticipates that this hearing will create a framework by which the various proposals can be fully evaluated.

However, because of the time constraints and the wide variety of topics we will consider today, I ask our nongovernmental witnesses to limit their presentations to 5 minutes. Of course, the full written statements of the witnesses will be entered into the record in their entirety.

At this time I would yield to my colleague, Mr. Hancock, for any opening statement he may have.

Mr. Hancock. No statement, Mr. Chairman.

Mr. McNulty. We will proceed and welcome Mr. Kleczka of Wisconsin.

STATEMENT OF HON. GERALD D. KLECZKA, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WISCONSIN

Mr. KLECZKA. Mr. Chairman, thank you for this opportunity to speak on behalf of my proposal to repeal section 530 of the Revenue Act of 1978. The debate centers on the misclassification of employees as independent contractors. Last year, as a member of the Committee on Government Operations, we considered this problem and I learned a lot about how section 530 is used to deliberately misclassify workers. I remain deeply concerned about this problem.

Before describing how and why section 530 results in the unfair treatment of workers, I want to provide some context for understanding it. There are many classifications of jobs, but only two matter for Federal tax purposes—employee and independent contractor. If a worker is an employee, the employer is responsible for the FICA tax, the FUTA tax, and withholding on wages paid.

If the worker is an independent contractor, the service recipient has no tax liabilities toward the independent contractor. The independent contractor pays all applicable taxes. This creates a strong incentive for businesses to misclassify their workers as independent contractors.

Not surprisingly, many contractors came to this conclusion years ago. During the late 1960s, a number of employers were misclassifying their workers and were forced to correct it. This resulted in significant tax penalties for those employers.

The basis for the legislative relief was that the test for determining whether a worker is an employee or not is too subjective. While section 530 eliminates much of the subjectivity, it permits and promotes abusive classification.

In broad terms, section 530 states that if an employer has a reasonable basis for treating its workers as independent contractors, the IRS may not challenge that classification. One reasonable basis is where the employer was audited once by the IRS and the classification of be workers was not challenged. This is troublesome because the IRS has limited budget resources, and it means that after one audit, the employer is free to misclassify at will.

Consequently, there is no fear of review by the IRS. The two most obvious examples of the problem is the loss to the Federal Treasury. Two 1989 IRS reports found that 1 of 7 employers misclassified over 3 million workers with $15 billion in compensation. This resulted in a reported loss of $1.6 billion to the Federal Treasury.

This report also stated that there was no reason to believe that this amount has declined since 1984.

In testimony before the Ways and Means Committee last July, the General Accounting Office reported that the IRS reclassified 337,000 workers as employees of small businesses and proposed $467 million in tax assessments.

The IRS testified before the Committee on Government Operations that general contractors in the construction industry have one of the highest rates of misclassification of any industry group. One of their studies revealed that over 6,000 informational returns or Form 1099 could not be matched to taxpayers accounts. That resulted in an estimated loss of $91 million to the Federal Treasury.

In another example, the IRS testified that in one district, 20 percent of the employers in the residential construction industry misclassified 64 percent of employees as independent contractors. This resulted in a revenue loss of some $3.8 million to the Treasury.

Mr. Chairman, these figures are staggering. I believe they are only the tip of the iceberg. At the very least, they demonstrate just how serious the problem of misclassification is.

In addition to the loss to the Federal Treasury, misclassification hurts America's workers because employees are entitled to workmen's compensation; independent contractors are not. Employees are eligible for employer-provided health benefits; independent contractors are not. Employees may participate in pension plans sponsored by their employers to save for the future; independent contractors may not.

As I am sure you can see workers, who are misclassified as independent contractors are seriously injured and the IRS can do nothing to correct the problem. Section 530 prevents them from acting. Perhaps the worst problem caused by section 530 is the effect on the construction industry as a whole. The market in which general contractors bid for jobs is extremely competitive. Bids are won and lost over small differences in price. Consequently, if one contractor can treat its employees as independent contractors, it can lower its labor costs and afford to bid less on jobs.

In some cases labor costs can drop by 25 percent. The net result of this is that it forces honest contractors to engage in dishonest practices in order to remain competitive. We simply cannot allow this situation to continue.

Section 530 was enacted to eliminate subjectivity and make classification of job status easier. However, its enactment opened the door for tremendous abuse. Eliminating section 530 for the construction industry in my estimation will end this abuse. It will restore the IRS oversight role in reviewing job classification in an industry noted for its abuse of the employment tax laws.

Finally, it will restore a level playing field for all contractors. Mr. Chairman and members, thank you for this opportunity to speak on behalf of this proposal to eliminate section 530 from the construction industry. I look forward to working with you on this legislation.

[The prepared statement follows:]

Statement of Gerald D. Kleczka

Before the Subcommittee on Select Revenue Measures

Committee on Ways and Means

September 21, 1993

Thank you, Mr. Chairman, for this opportunity to speak on behalf of my proposal to repeal section 530 of the Revenue Act of 1978 for the construction industry. The core of the debate surrounding section 530 is the misclassification of workers as independent contractors. This is not a new issue to me. As a member of the Committee on Government Operations last year, we considered the nature and extent of the problem of misclassification. At that time, I learned a great deal about how and why employers try to classify their workers as independent contractors, and that section 530 is frequently used by these employers to deliberately misclassify. I remain deeply concerned that the problem continues today, and believe that my proposal takes an important step toward curbing abusive misclassification.

Before describing how and why section 530 perpetuates unfair treatment of workers, I want to provide some context for understanding it. The American workplace contains a great many types of jobs as well as classifications of jobs. However, only two are important for federal tax purposes. They are employee and independent contractor. The status of a worker as either an independent contractor or an employee largely determines how their federal tax liabilities are determined. If a worker is an employee, the employer must withhold certain amounts from the employees' wages, the employer must also pay the FICA tax, and the employer must pay the FUTA tax. However, if the worker is an independent contractor, the person paying for the work owes no FICA tax, owes no FUTA tax, and is not required to withhold any sums from the amount paid. The independent contractor pays all the applicable taxes. Thus, I think it is quite clear that the person paying for work has a very strong incentive to classify its workers as independent contractors, regardless of whether the workers are employees or independent contractors.

Not surprisingly, many contractors in the construction industry came to this conclusion years ago. During the late 1960s, a number of employers who were found to be engaging in this practice were forced by the IRS to reclassify their workers as employees. As a result, the employers were liable for substantial sums of unpaid federal employment taxes. In response to these assessments, employers lobbied for and Congress enacted section 530. The basis for this legislative relief was that the test for determining whether a worker was an employee or independent contractor was too subjective. In all fairness, this was true to a degree, and some clarity was needed. However, while section 530 eliminates subjectivity, it also permits and promotes abusive classification.

Section 530 eliminates the subjectivity by providing a safe harbor for classifying workers as independent contractors. In broad terms, it states that if an employer has a reasonable basis for treating its workers as independent contractors, the IRS may not challenge that classification. One of the reasonable bases is where the employer was audited by the IRS once, and the classification of its workers was not challenged. If this occurs the IRS may not review the classification at a later date.

While this prior audit rule helped employers who made honest mistakes in classifying their workers, it was quickly exploited by employers seeking to evade paying their fair share of employment taxes, and is particularly troublesome given the fact that the IRS has only limited resources. It essentially means that if the IRS does not examine every possible aspect of an employer's return, the employer is free to misclassify its workers, and is not subject to any reasonable review by the IRS. It amounts to a license to evade taxation.

Armed with section 530, a significant number of employers now misclassify their workers as independent contractors with impunity, knowing the IRS cannot stop them.

The harm caused by this misclassification is great and occurs on many different fronts. Beginning with the most obvious, the loss of funds to the federal treasury, two 1989 IRS reports found that 1 of 7 employers misclassified over 3 million workers with $15 billion in compensation. This reportedly resulted in a loss of $1.6 billion in revenue in 1984. Moreover, the reports state that there is no reason to believe that the 1984 loss has declined.

More recently, in testimony before the Ways and Means Committee in July 1992, the General Accounting Office reported that in a special program, which focused on small businesses, the IRS reclassified 337,000 workers as employees and proposed $467 million in tax assessments.

The IRS testified before the Committee on Government Operations that general contractors in the construction industry have one of the highest misclassification rates of any industry group. One IRS study revealed over 6,000 informational returns or Forms 1099 that could not be matched to taxpayers' accounts. The IRS estimated that this resulted in a loss of $91 million to the federal treasury.

In another example, the IRS testified that in one district, 20 percent of employers in the residential construction industry misclassified 64 percent of employees as independent contractors. This resulted in a $3.8 million revenue loss for the federal treasury.

Mr. Chairman, these figures are staggering. I believe the numbers are only the tip of the iceberg, and I believe the loss to the U.S. Treasury is far greater than even these studies indicate. At the very least, the studies demonstrate just how serious the problem of misclassification is for America. In a time when the federal government is strapped for money, and is cutting Medicare benefits, veterans pay, retirees benefits, etc., we simply cannot afford to allow such huge losses in revenue to occur through deliberate abuse of the law.

In addition to the loss to the treasury, misclassification endangers America's workers. Employees are entitled to such protections as workers' compensation benefits for on the job injuries. Independent contractors, however, are not. Employees are eligible for employer provided health benefits. Independent contractors are not. Employees may participate in pension plans sponsored by their employer to save for the future. Independent contractors may not. As I'm sure you can see, workers who are misclassified as independent contractors are seriously injured, and the IRS can do nothing to correct the problem. Section 530 prevents them from acting.

In addition to all the harms I have mentioned, perhaps the worst problem caused by section 530 is its effect on the construction industry as a whole. The market in which general contractors bid for jobs is extremely competitive. Bids are won and lost over very small differences in price. Consequently, if one contractor can treat its employees as independent contractors and lower its operating costs, that contractor can afford to bid lower than its competitors which correctly treat the workers as employees. In fact, by deliberately misclassifying workers, a contractor can lower its costs by up to 25 percent.

The net result is that such deliberate misclassification forces honest contractors to engage in dishonest practices in order to remain competitive. Thus, section 530 not only permits individual contractors to abuse the employment tax laws, but forces others to follow suit in order to survive.

We simply cannot afford to allow this situation to continue. I realize that section 530 was enacted to eliminate subjectivity and make the classification of job status easier. However, I also realize that its enactment opened the door for tremendous abuse that could not be foreseen at the time. We must act now to end this abuse. Eliminating section 530 for the construction industry does just that. It terminates the unfair provision that prevents the IRS from reclassifying deliberate abuses and restores oversight to an industry noted for its abuses of the employment tax laws. It protects workers from unfair denial of protections enacted for their health and safety. And finally, it restores a level playing field for all contractors to compete in.

Mr. Chairman, thank you for this opportunity to speak on behalf of my proposal to eliminate section 530 for the construction industry. I look forward to working with you on this legislation.

Mr. McNulty. We thank our colleague.

Jerry, the proposal to repeal the section 530 safe harbor for construction workers would result in employee status being forced upon some workers who would otherwise have met the requirements for independent contractor classification, for example, subcontractors who are self-employed.

What provisions would your proposal make for people in this category?

Mr. Kleczka. For those who have been categorized as independent contractors, I believe my repeal, an audit of IRS, would reveal those employees to be independent contractors and their status would remain as it is.

Mr. McNulty. In a report issued by the GAO entitled "Approaches for Improving Independent Contractor Compliance, July 1992," there is a recommendation to apply the income tax withholding rules to all compensation paid for services without regard to the classification used by the worker performing the services.

What is your view on this recommendation?

Mr. Kleczka. Mr. Chairman, I believe that is an option that not only this subcommittee but the full committee could look at.

Mr. McNulty. Thank you.

Do other colleagues have questions of Congressman Kleczka?

Mr. Hancock. Thank you, Mr. Chairman.

You know, one of the things that we have talked about here in the Congress is the creation of new jobs and small businesses. I do deal in some of these construction jobs. Some are legitimate and hopefully we won't get into a situation where we force the small businesses, the truly independent contractor, to have to be reclassified, where he will have to become an employee of the general contractor.

I would caution us on that. We do not want to do anything in this regulation that would prohibit or make it illegal for the truly independent contractor to operate as an individual. I recognize that if he has 8 or 10 employees, he would be considered an independent contractor.

I would like to caution that we don't want to do anything to jeopardize the opportunities of individuals to operate as independent contractors by making this law so arbitrary that it is the only way that the truly independent individual can work in the construction industry.

Mr. Kleczka. I agree. In fact, it is not the intent of this author to change anything for the bona fide independent contractor. However, for those employers in an effort to skirt their liabilities, be it the FICA or pension or health benefits, those are the ones we are trying to get at today.

Mr. Hancock. I understand. When you take an individual who works for two or three different construction companies during the year, that individual is still an independent contractor and I think should be able to maintain his independence. I would hope that we don't get into the situation where that individual can't operate under those terms.

Thank you very much.

Mr. Kleczka. Thank you.

Mr. McNulty. If there are no further questions for Congressman Kleczka, we thank him for his testimony.

Mr. Kleczka. Thank you.

Mr. McNulty. Congressman Tom Lantos was due to appear as a witness this morning, but is now unable to attend. I ask unanimous consent that his statement appear in the record.

Without objection, so ordered.

[The statement of Mr. Lantos follows:]

Congress of the United States
House of Representatives
Washington, DC 20515

Statement of Rep. Tom Lantos
Before the Subcommittee on Select Revenue Measures
Committee on Ways and Means

September 21, 1993

Thank you, Mr. Chairman, for including the important issue of independent contractors among the diverse topics you are considering today. My esteemed colleague from Connecticut and I appreciate this opportunity to discuss the proposal to eliminate Section 530 coverage of the construction industry and our related suggestions, which are embodied in H.R. 3069 which we introduced last week.

The controversial subject of independent contractors, to which you devoted a lengthy day of hearing in the last session of Congress, looms even larger today. The so-called "jobless recovery" we are undergoing points to major, structural changes in the American labor market. Whether we call it "downsizing", "just-in-time", "core and ring", "out-sourcing", "privatization of government functions" or simply "contracting out", we are seeing a decline in the traditional pattern of long-term, full-time employment. Increasing reliance on contingent workers, including temporary, part-time and contractor personnel, characterizes most industries. It affects both workers and employers significantly.

During the six years I chaired the Employment and Housing Subcommittee of the Government Operations Committee, I learned much about the uses and abuses of contract labor. My colleague and I have introduced legislation in an effort to remedy some of the abuses which were brought to our attention.

But first let me quote again the words of Chairman Rostenkowski at a 1979 hearing on independent contractors. He said: "We in this country have benefitted much from the spirit and independence of the truly self-employed individual. It is not the purpose of this hearing to dampen the spirit and creativity of these individuals."

I certainly agree and recognize the appropriate and valuable roles of many who work as independent contractors. It is the misuse of independent contractor status and its serious adverse effects on both employers and workers, in construction and numerous other industries, that so concerns me.

An employer who deals with a contractor instead of an employee escapes many obligations including paying half of Social Security tax, unemployment tax, workers compensation insurance, withholding income taxes, and providing benefits such as vacation, sick and family leave, health and life insurance, pensions, etc. The employer also is not required to comply with the wage-hour and child labor provisions of the Fair Labor Standards Act, occupational safety and health, or civil rights laws. Benefits can add as much as 35% to payroll costs today; we may face additional taxes on employers under a new health care program. Clearly, these costs weigh heavily on the bottom line; they can determine whether a company wins bids and makes a profit. Before hiring an employee, an employer will certainly consider the possibility of a contingent work arrangement such as a contract. This may be a legal and appropriate arrangement, but it also may be an illegal cost-cutting maneuver, harmful to workers, competitors, and the Federal treasury.

My colleague can describe in detail the serious harm suffered by his law-abiding constituents who lost on bids for Connecticut construction projects to out-of-state competitors who misclassified their workers and treated them as independent contractors.

What does this mean to the worker? As a contractor he or she may receive higher take-home pay and may be allowed to deduct more business expenses from income taxes. Unfortunately, in all too many cases there is collusion between an employer and a contract worker which enables the worker to avoid paying income taxes. Cash payments fuel an underground economy of worrisome dimensions.

But the law-abiding independent contractor loses a safety net of protection available to employees. He or she may not even be aware until misfortune strikes that there is no unemployment insurance, worker's compensation, emergency leave, or even social security available. Whether the worker realizes the implications of being treated as a contractor or not, he or she usually cannot argue with an employer about such classification. In today's economy it is likely to be: "Take it or I'll contract with one of the crowd of applicants at my door!"

When the Internal Revenue Service determines that an employer has misclassified employees as independent contractors, it assesses back taxes, interest and penalties, which can amount to a devastating blow. Faced with complaints of overzealous enforcement by IRS in the 1970's, Congress enacted Section 530 which provides several safe harbors for employers to escape IRS assessments for past misclasssification and to permit continued misclassification in the future. Strong evidence at many Congressional hearings shows that this law has several negative effects: one, it results in similarly situated employers being treated very differently under the tax law; two, it allows--and actually encourages--businesses to undercut competitors through unfair practices; three, it leaves workers exploited and unprotected; and four--surely an issue of prime importance to all of us--it deprives the Federal government of significant revenue.

This is not a small problem we are addressing. IRS reported that in 1984 one in seven employers misclassified some three million workers with $16 billion in compensation. The Social Security system, state unemployment funds and the general treasury are all losing money. More significantly, these estimates, according to IRS, "...are conservative. They represent employers with employment tax filing requirements but do not include withholding and employment tax noncompliance for employers who are completely noncompliant with employment taxes regulations." In other words, they do not include the submerged bulk of the iceberg, the willful violators.

Eventually it may be desirable to repeal Section 530 altogether, but today we see the problem of noncompliance as so rampant in the construction industry that we are pleased to support the proposal before you to eliminate Section 530 coverage of this industry. Since use of bona fide independent contractors, such as a truly freelance craftsman, is available, we recommend elimination of the safe harbors --loopholes, really--which 530 gives for past and future misclassification.

In addition to removing Section 530 protection from those construction employers who misclassify employees as independent contractors, we recommend that 530 be modified for all other industries. Our major proposal is a one-year amnesty or waiver of tax liability for employers who misclassified their employees based on a good faith misinterpretation of common law rules and who filed the required tax forms, such as 1099's. We believe that such an opportunity will induce many employers to "enter the system", which would be a win-win event for them, their workers and the IRS.

We also recommend deletion from Section 530 of the safe harbor based on any prior IRS audit unless the audit was conducted for employment tax purposes within the previous three years.

Although very few cases have arisen in which state or local government entities have sought 530 protection for misclassification of their employees, we believe that no such exemptions are appropriate and therefore would exclude them from Section 530.

Our bill eliminates Section 1706 of the Tax Reform Act of 1986 which gave unjustified special treatment to a group of technical services professionals. This repeal was advocated by several witnesses in your committee's 1992 hearing.

Our proposal requires employers to include with payments for services provided by contractors a statement informing the worker of 1) obligations for payment of FICA and other taxes, 2) the procedure for requesting IRS to review the contract status, 3) the absence of fringe benefits and statutory protections, and 4) potential tax benefits available to the self-employed. The IRS could prepare standardized information which legitimate employers would not object to providing to their contractors. We have heard of too many instances where workers suffered because they were not aware of what contractor status meant to them financially or otherwise.

Mr. Chairman, I am well aware that the independent contractor issue is an emotional one which has been before your committee many times. I urge you and your colleagues to deal with it this year as a valid source of revenue, a measure of equity for law-abiding employers, and a small step to assist victims of the movement toward a contingent workforce. You will restore the safety net we have established for countless thousands of workers--skilled craftspersons, immigrant janitors, nurses, taxi drivers and others from all walks of life.

Thank you for your attention to this issue.

Mr. McNulty. I would ask for the same consideration for Congressman Christopher Shays. Without objection, his statement will appear in the record.

[The statement of Mr. Shays follows:]

STATEMENT OF CONGRESSMAN CHRISTOPHER SHAYS
WAYS AND MEANS COMMITTEE
SUBCOMMITTEE ON SELECT REVENUE
September 21, 1993

Mr. Chairman, thank you for considering the issue of misclassifying employees as independent contractors as part of today's hearing. My friend, Congressman Lantos, and I appreciate this opportunity to testify in support of eliminating Section 530 coverage of the construction industry as well as the other aspects of our bill, H.R. 3069.

First, I would like to join Congressman Lantos in acknowledging the need to protect the rights of contractors who are truly independent and self-employed -- our nation's spirited entrepreneurs who are hard-working and conscientious.

When employees are improperly classified it hurts the worker, who does not receive the benefits to which he or she is entitled; it hurts the honest employer, who loses bids to competitors who are able to illegally cut their labor costs; and finally, it hurts the government, which loses billions of dollars in tax revenues.

Last year, our Government Operations Subcommittee on Employment and Housing held a hearing to examine the implications of this pernicious problem, with particular attention to how it affects the employee.

We listened to testimony from several employees who worked for unscrupulous contractors who intentionally misclassified them. The workers described how their employers cut corners on overtime pay, Social Security taxes, federal unemployment taxes, unemployment compensation, workers' compensation and federal withholding taxes as well as other employees benefits.

The employees said they knew their bosses were breaking the law and knew they were being cheated out of important health and welfare benefits, but in each case, the employees said they could not protest because they needed the work.

Employees discover the real disadvantage to their independent status when crisis strikes. The New York State Unemployment Commissioner told us how some employees do not know they are being treated as independent contractors and only discover this fact when they lose their jobs and apply for unemployment benefits. They are shocked to learn that they are not eligible for benefits and their only recourse is to engage in a legal battle with their former employer.

The law-abiding employer is seriously hurt by misclassification since he cannot compete on a level playing field with those who illegally cut labor costs.

One employer from my state told our subcommittee how he lost a $3.5 million contract to a low bidder who hired all 50 employees as individual subcontractors. As a result, the state and the federal government failed to receive any taxes, unemployment or workers compensation payments.

Our subcommittee was disturbed to learn that to cover themselves, some employers put a handful of employees legitimately on the payroll so that in the event an uncovered workers is injured on the job, they can use the covered employee's name and compensation benefits. We were troubled to learn this kind of scam is not uncommon.

While we understand that Section 530 of the Revenue Act of 1978, the so-called "Safe Harbor" clause, was passed to protect employers from overly aggressive enforcement by the Internal Revenue Service (IRS), and particularly, the imposition of very harsh fines and penalties, we are concerned this provision has limited the ability of the IRS to address this problem.

As you know, because of Section 530, employers are allowed to continue to misclassify workers if they can demonstrate they have a reasonable basis for classifying employees as independent contractors. This would include a past IRS audit, an established, long-standing recognized industry practice or an IRS ruling or judicial precedent.

Our subcommittee heard testimony from a high ranking IRS official who stated that Section 530 hamstrings the IRS from effectively enforcing the laws and dealing with the misclassification problem.

After listening to these witnesses, Chairman Lantos and I concluded it was imperative we introduce H.R. 3069 to try to put a stop to these abuses.

First, our bill would provide amnesty for one year from back taxes and penalties to employers who in "good faith" misclassified their employees. These employees would have to prove they filed all the required tax forms, including 1099s, and they would have to pledge that they would reclassify their workers for the future. Moreover, we would encourage the IRS to maintain a "watch list" of these employers to ensure they continue to classify correctly.

Our intent in offering this one-year amnesty is to give employers who feel they have unintentionally misclassified the opportunity to come into compliance. We believe there are many honest employers out there -- one of whom testified at our hearing -- who would take advantage of the opportunity to set the record straight. We do not feel, however, those who willfully misclassified for financial gain and failed to file forms with the IRS should be afforded this protection.

Second, our bill would eliminate the "prior audit" safe haven under Section 530, which allows employers to continue to misclassify employees solely because they were previously audited by the IRS.

We strongly feel this protection should be eliminated. It makes little sense to us to continue to allow the wrongful classification of employees just because the company received a previous audit, which may have had nothing to do with the issue of misclassification.

Third, our bill would require the states to follow the Federal definition of employee for the purposes of unemployment compensation. We feel this provision would help clarify a great deal of confusion between differing federal and state statutes and interpretations.

Fourth, if workers are legitimately independent contractors, our legislation would require that prime contractors notify them of all their tax obligations as well as their statutory rights and protections as subcontractors.

We urge the subcommittee to consider the proposals before it today and in its great wisdom craft the most effective solution to this problem.

Mr. Chairman, thank you again for allowing us to testify on this important issue.

Mr. McNulty. At this time, I would like to welcome another colleague to the hearing, Congressman Alan Wheat of Missouri.

STATEMENT OF HON. ALAN WHEAT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI

Mr. Wheat. Thank you, Mr. Chairman. I appreciate the opportunity to testify before you this morning. I would ask unanimous consent that my entire statement be made a part of the record and I would summarize it and also the statement of Mr. Mike Herman, who is the managing partner of the Kansas City Royals baseball organization at this time.

Mr. McNulty. Without objection.

[The statement of Mr. Herman follows:]

STATEMENT OF MICHAEL E. HERMAN
ON PROPOSED CIVIC ASSETS LEGISLATION
HEARING ON MISCELLANEOUS REVENUE ISSUES
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

SEPTEMBER 21, 1993

Mr. Chairman and members of the Committee, I greatly appreciate the opportunity to present a statement in support of the legislation that Congressman Alan Wheat will introduce in the near future. This legislation is necessary to answer questions in the Internal Revenue Code with respect to a proposed gift by the late Mr. Ewing M. Kauffman.

Before his death this year, Mr. Kauffman worked on a Succession Plan for the Kansas City Royals so that the team could remain in Kansas City after his death. I can attest to this as I had the extreme privilege of working closely with this extraordinary individual for over 20 years. He was a father figure to me and to a great many others in our community. He will be greatly missed.

Because of our close association, Mr. Kauffman often asked me to represent him with respect to the Royals. Now under the Trust which holds the Royals stock, Mrs. Kauffman and I, as trustees, have the responsibility of administering the stock in accordance with his wishes. His fervent desire was that the Royals remain in Kansas City for as long as possible.

Mr. Kauffman early on realized just how important a major league baseball team would be to our City. Kansas City has a great baseball tradition, with the Kansas City Blues, the Kansas City Monarchs and the Kansas City Athletics. After we lost the Athletics, Mr. Kauffman took an enormous financial risk by purchasing the expansion franchise offered by the American League.

Mr. Kauffman, never one to settle for second best, then set out to build a first-rate organization. Mr. Kauffman had a knack of generating enthusiasm in others which caused them to excel beyond their expectations. Mr. Kauffman was able to work his magic on the Royals and the team responded by winning six division titles, two American League Championships, and one World Series, all within 24 years of its founding. (I also note with pride, the Royals are the only team in Major League history, never to have finished last.)

During the two and one half decades that the Royals have existed, they have become an integral part of Kansas City, not only from a financial and recreational standpoint, but also because many players (non-Kansas Citians at first) have chosen to live in our City during and after their careers. The team and the players are truly part of our community. The players continually donate their time and talents for charitable activities, and in turn, the community responds to them. I believe Mr. Kauffman fostered within the Royals, this sense of community service. In this vein, Mr. Kauffman by his example made his people aware of what was appropriate behavior on and off the field.

It is self evident and goes without saying that the existence of the Royals in Kansas City is vital to our community in many, many other ways.

As you may know, Mr. Kauffman died on August 1. However, before his death he developed a Succession Plan for the Royals so that after he was gone, there would be a way to keep the Royals in Kansas City. Mr. Kauffman worked on this plan for almost two years.

Under the Plan, Mr. Kauffman's stock in the Royals would be split into two classes, Class A voting common and Class B non-voting common, and another class (Class C non-voting) would also be authorized.

Mr. Kauffman's Trust would sell the Class A stock to a partnership of five individuals who would control the team with one of the five acting as the decision maker. This individual would be obligated to operate the team under the rules that govern Major League Baseball.

His Trust would donate the Class B stock to the Greater Kansas City Community Foundation, a well recognized public charity, as well as donate $40,000,000 in cash to this Foundation to purchase additional shares of Royals' Class B stock. Mr. Kauffman's Trust and Mrs. Kauffman would also donate an additional $10,000,000 to the Foundation to purchase Class C stock. Others in Kansas City would then donate another $40,000,000 to the Foundation to purchase the remaining shares of Class C stock.

Thereafter, the Royals would continue to operate in Kansas City as a taxable entity with cash reserves available to fund the foreseeable operating losses for the next several years. During this time the Partnership would attempt to sell the team to a local purchaser. For a period of six years, the Partnership would be restricted from selling the Class A stock to anyone other than a person who would agree to keep the team in Kansas City. After the six year period, this restriction would disappear.

The Class B and Class C stock held by the Community Foundation would have no restrictions as to sale except that Major League Baseball would have the right to approve the buyer of the stock (as it does with respect to all transfers of ownership interests in baseball franchises). Moreover, the purchaser of the Class A stock would also be required to purchase the Class B and Class C stock, but only if the Community Foundation elected to sell.

Thereafter when the Royals are sold, the proceeds would be distributed:

(i) first, to the Community Foundation as the sole holder of the Class C stock in an amount equal to its purchase price for the Class C stock;

(ii) then to the Partnership, the holder of the Class A stock, in an amount equal to its purchase price for the Class A stock;

(iii) then to the Community Foundation as the holder of the Class C stock, in an amount equal to 5% of the remaining proceeds;

(iv) then to the Partnership as the holder of all Class A stock, an amount all of which will be donated to charity; and

(v) lastly, the remaining amount to the Community Foundation as the holder of the Class B stock.

In March, 1993, Mr. Kauffman submitted a ruling request to the Internal Revenue Service with respect to the tax treatment of the transactions contemplated in the Succession Plan. Although the Internal Revenue Service has yet to issue its ruling, it has raised a number of questions which they believe may not be capable of being resolved in the Internal Revenue Code as presently drafted. It is anticipated that we should have a determination from the Internal Revenue Service within the next 30 to 60 days.

Mr. Kauffman had anticipated that he might not live long enough to be assured that the Succession Plan would be implemented as proposed. Therefore, in the Trust Agreement, Mrs. Kauffman and I as Trustees are directed to exert all reasonable efforts to proceed with the Succession Plan and if that is not possible, then to transfer the Royals stock to the Ewing M. Kauffman Foundation.

In essence, there should be no distinction drawn between the transfer of the Royals stock in accordance with the Succession Plan and the transfer of the stock to the Kauffman Foundation. Both should be treated as charitable contributions.

Mr. Kauffman first looked to see if the gift of the Royals could be made to the Kauffman Foundation. However, he was advised that the Kauffman Foundation could not be the recipient of the Royals stock, in as much as this Foundation is a "private foundation" subject to its own special rules in the Internal Revenue Code. As such, the Kauffman Foundation should not fund the team's operating losses and so would have no alternative but to sell the Royals quickly. This would be disadvantageous to the people of Kansas City in that it would be very likely that an outsider would come in, buy the team and move it. Moreover, Major League Baseball would not be comfortable with a charity owning and operating a baseball team. Also, the strings on the gift to assure that the team remain in Kansas City might disqualify the donation.

Mr. Kauffman was a very generous individual and the Succession Plan is evidence of this. Under the Plan, he and Mrs. Kauffman will give assets worth over $175,000,000 for the benefit of Kansas City, all of this, in order to keep the Royals in our community. The transactions have been scrutinized carefully and I can assure you that under the Plan, no one will benefit except the people of Kansas City.

We understand that Congressman Wheat will be submitting a carefully crafted bill that addresses the problems that may exist in the Internal Revenue Code. This bill has been reviewed by the staff of the Joint Committee on Internal Revenue Taxation. The bill will make clear that the activities of preserving long standing community assets or enterprises that are integral to the life of the community are activities that are charitable in nature. In addition, the bill goes a long way to avoid potential abuses by providing that the donor will be allowed only an estate tax deduction provided the donor gives all of his interest to a community foundation. Furthermore, the family of the donor cannot have any continuing interest in the enterprise. Also, requirements on the gift that further the civic asset remaining in the community or that are required by another authority, such as in this case Major League Baseball, will not defeat the charitable deductions.

In closing, I want to thank you for this opportunity to present this statement in support of Congressman Wheat's bill.

Mr. WHEAT. Thank you. I appreciate the opportunity to testify.

I want to make it clear I am not speaking just on my own behalf, but on behalf of the two Senators who represent the State of Missouri, both of whom have been very active in legislation that we seek to present to you today, as well as the Kansas City Royals baseball team and the great majority of the citizens of the greater Kansas City area who have expressed their support through public solicitation, direct support, as well as having both the Jackson County Legislature and the Kansas City Missouri City Council pass resolutions in support of what I propose today.

You may be aware that a gentleman by the name of Ewing Kauffman died recently who had for many years been the owner of the Kansas City Royals baseball club. Mr. Kauffman was a man who was admired and revered in the greater Kansas City area and was very, very generous in terms of charitable contributions throughout his lifetime, so generous that in fact his carryover deduction for income tax purposes is in the hundreds of million dollars range at this time.

Mr. Kauffman and his wife were the sole owners of the Kansas City Royals baseball team, but made provisions before Mr. Kauffman died to set up what we believe is a very generous succession plan so that the Kansas City Royals baseball team could remain in the Kansas City area.

The way that Mr. Kauffman proposed to do this was to donate the baseball team to a community trust in Kansas City that is a charitable organization. I have legislation here that explains how that is done and I could go through all the different classes of stock that are involved and all the regulations.

Let me sum it up by saying the problem is that a community trust might be required to sell the baseball team because it is frankly a losing proposition on an annual basis and it is one of some significant assets. The law is not clear at this point in time whether a community trust could in fact hold a significant asset like this for a period of time for the purpose of maintaining it within a city. That is what we seek to do today, to present legislation which will clarify that law and allow a community trust on a charitable basis to continue to operate the baseball team.

I should also mention that the baseball team itself would be operated in such a way that it would continue to be a full taxpaying corporate entity and only for the purposes of the transfer would there be no tax liabilities.

I should also add that in our particular case, there would be no revenue effect to the Federal Treasury because whether the baseball team is donated to the community trust or whether it is donated to a private charitable entity that Mr. Kauffman had set up over the last few years, it was his intention that it be donated to a charitable entity. The only real question for this committee is whether that charitable entity can then maintain the baseball team for a period of time until, in accord with Mr. Kauffman's wishes, a local buyer can be found or whether that charitable entity would then be required to sell the baseball team immediately.

If the baseball team were sold immediately, I don't think there is any doubt because of the economics of major league baseball today that in a small market town like Kansas City the team would be sold to an outside buyer and outside of Kansas City.

Understanding that there is no revenue impact for the Federal Government, that Mr. Kauffman has been very generous with his succession plan, that the money is being raised locally to pay for the operating losses of the team, and that all that we are asking in essence is time in order to find a local buyer. We would ask that this committee support the legislation that we are introducing that would allow the charitable entity in Kansas City to continue to operate the baseball team for a period of time until a local buyer can be found.

With that, Mr. Chairman, I would submit my statement and be very happy to answer any questions that you would have about how this plan would operate or what its ultimate effect would be.

[The prepared statement follows:]

STATEMENT OF
THE HONORABLE ALAN WHEAT
ON PROPOSED CIVIC ASSET LEGISLATION

HEARING ON MISCELLANEOUS REVENUE MEASURES
SUBCOMMITEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

September 21, 1993

Mr. Chairman and members of the committee, I appreciate the opportunity to appear before you today. I am here to discuss legislation that I will introduce soon that attempts to solve a troubling tax problem that could hinder efforts to preserve a major civic asset for the citizens of Kansas City. That asset is the Kansas City Royals Major League Baseball team.

You may have read in the newspapers that Ewing Kauffman, the owner of the Kansas City Royals, died recently of cancer. Mr. Kauffman's death puts the future status of the Royals in a kind of tax code limbo. The intent of my legislation is to remove the cloud the tax code places over the remarkably generous succession plan Mr. Kauffman put together, a plan designed specifically to allow his fellow citizens to keep the Royals in Kansas City.

Ewing Kauffman, for those of you who don't know of him, was a long-time benefactor of Kansas City. A famed entrepreneur and philanthropist, he made a lot of money in his lifetime, and gave a lot of it back to charitable purposes in Kansas City. "Mr. K", as he was affectionately known, had a special interest in helping children help themselves. He gained national notice some years ago with his promise of a college education to whole graduating classes of students at a Kansas City high school if those young people would stay in school and stay off drugs. True to his word, he delivered on that promise.

One of Mr. Kauffman's greatest legacies in Kansas City is the Royals baseball team. After our previous baseball team -- the Athletics -- left Kansas City for Oakland, Kansas City acquired an expansion franchise, the Royals, in 1969, but only because Mr. Kauffman was willing to put up the money and take the risk when no one else would do so. At that time, serious questions existed about the economic realities of the Kansas City baseball market, questions that Mr. K and fans from across the Midwest have since answered with 25 years of enthusiastic fan support and sound financial management.

Today, Mr. Chairman, it is hard to exaggerate the bond between the Royals and Kansas City. We have an area population of only about 1.5 million -- the smallest of any major league baseball city. But the Royals have enjoyed attendance exceeding 2 million per year--a number that many other teams can only dream about. Based on population, Mr. Chairman, that would be like the Yankees and Mets drawing 10 million fans each.

The Royals have rewarded us with success--numerous division titles, two American League Championships, and victory over St. Louis in the memorable all-Missouri World Series in 1985. They are the only team in baseall never to have finished last in their division. But more importantly, they have gradually been woven into the very fabric of the community. As the Royals celebrate their 25th anniversary in Kansas City, we celebrate over two decades of a civic treasure that has created bonds between hometown people from diverse backgrounds and joined them together in civic and charitable work throughout the community.

The Royals have become an important source of jobs in Kansas City, an economic anchor that is key to Kansas City's present and future. The team draws over a million fans a year from outside the metropolitan area, and it is estimated that these fans create at least $200 million in economic activity for the area economy. For example, if you live in Iowa and want to get away for a few days, stay in a nice hotel ands see a good baseball game, Kansas City is the obvious choice. In fact, we have season ticket holders in Iowa -- as we do in Nebraska, Oklahoma, Arkansas, and other states in the Midwest.

The Royals also help us attract national conventions and new businesses. When a business is deciding whether to locate in L.A. or Atlanta or Houston, local sports franchises probably are not going to enter into the decision. But a lot of businesses come to Kansas City partly for the quality of life -- and the Royals are significant factor in that regard, raising Kansas City's visibility and allure as a "major league" city with major league sports and entertainment.

So what happens to the team now that Mr. Kauffman has passed away? The short answer is that if we don't pass this legislation, no one can be sure what will happen to the team. It is very possible that without passage of the legislation I am proposing, the team will soon be forced to leave our city.

Here's the problem: because of our limited population, the Royals also have limited TV revenue. TV revenue is the name of the game these days. In a larger market such as New York, George Steinbrenner could probably keep the Yankees afloat without a single fan in the stadium.

Not so in Kansas City. With player salaries soaring, the Royals are now losing money each year, a loss that Mr. Kauffman was willing to absorb (and, in fact, his estate will continue to absorb a portion of the losses under the plan he has proposed until a new buyer is found). But if the Kauffman plan is not allowed to go forward, it is at best questionable whether a new buyer can be found soon who will agree to keep the team in Kansas City and continue to absorb the losses.

What we hope is that in the near future a buyer will emerge, and that changes in the way Major Leage Baseball operates financially will soon come to pass that will help such a buyer emerge. For example, baseball has been discussing adopting TV revenue sharing, like professional football. That would make the Royals much more attractive to a buyer. Still, if no buyer can be found, then major league baseball ultimately will have to decide on the fate of the franchise, and on whether the Royals are moved from Kansas City.

What the Royals need right now is time -- time for a local buyer to emerge, and time for baseball to deal with revenue-sharing and other financial issues. Essentially, that's what my legislation would provide -- time.

Without enactment of this bill, the team will be transferred to the Kauffman Foundation, under the terms of Mr. Kauffman's estate plan. Because of fiduciary obligations, this private foundation would then have to act quickly to find a buyer for the team. Under this scenario, it is likely that an out-of-town buyer with deep pockets would then arrange with Major League Baseball to move the franchise out of Kansas City to a larger TV market, before a local buyer could step forward.

What Mr. Kauffman had intended, instead, is for the team to go to a local community trust--the Greater Kansas City Community Trust--for a period of years until a Kansas City buyer is found. During those interim years, private donors in Kansas City--many of whom have already stepped forward--would join the Kauffman estate in absorbing the team's losses.

If a Kansas City buyer cannot be found, then perhaps the team will be sold out of Kansas City anyway. In any event, the profits from the sale of the team--estimated at well over $100 million--will go to charity, either the Kauffman Foundation or the Greater Kansas City Community Trust.

The bottom line is, Mr. Kauffman is simply giving the profits from the team's sale to charity, an enormous act of personal generosity. Gifting these profits to charity was Mr. K's first wish. We are asking that Mr. Kauffman's second wish--the twin goal of his succession plan--also be granted: that when his team is given away, it be given back to the citizens of Kansas City. Unfortunately, it is not clear under current tax law that a charity, even a public charity like a community trust, can hold a baseball team under these circumstances.

As you know, community trusts sometimes desire to participate in preserving civic assets. Such assets typically have a long-standing association with the region, are patronized by a broad spectrum of the community, and are important to both its economy and identity.

My legislation amends the tax code to make it clear that a community trust is permitted to be involved in activities to foster the preservation of civic assets--important and long-standing features of the community.

If the legislation is passed, then the ownership of the team will be transferred to the community trust under the terms of Mr. Kauffman's estate plan. Under the succession plan, there is no financial cost or exposure to the charity. It is merely a holding entity for the team.

The legislation is fully generic. In our particular case, the main tax issue here is whether the contribution to a public charity of Kansas City Royals' stock by Mr. Kauffman will qualify for a federal estate tax deduction if the value of the stock is effectively restricted in the manner prescribed in the plan.

I want to emphasize to the Committee that this is not some thinly-veiled attempt to avoid tax that would otherwise be paid by the Kauffman estate--in fact, if this bill is not passed, the team will go to his private foundation and the Kauffman estate will still receive the tax deduction.

Although it would apply to the Royals situation, it would also apply to other appropriate cases that meet the strict criteria outlined in the bill. At the same time, the legislation is rigidly circumscribed to restrict its application and avoid any potential abuse. We have done that with the help of the Joint Tax Committee staff.

Mr. Chairman, since Mr. Kauffman's death, the Kansas City community has rallied behind this cause. Millions of dollars have been pledged from various corporate and charitable entities to support the plan. A limited partnership has been set up to guide the management of the team in the interim period.

Major League Baseball does not oppose the succession plan, and I am unaware of any local opposition to the plan. Its success depends on the cooperation of civic leaders, charities, Major League Baseball, and finally, the federal government. In that regard, I ask your cooperation.

Every city in the country has some civic assets that its residents have deep pride in and that have become a part of the fabric of the community. In most of those cases, the tax problem that the Royals face does not exist; for operas, libraries, museums, and most other such assets, the tax code already clearly allows charities to engage in activities to preserve those assets in the community. Currently, though, it is not so clear for sports franchises and other civic assets.

However, a sports franchise can be as much of an asset to a city as an opera or a museum. From the strictly economic perspective of a smaller city like Kansas City, some may view a sports frachise as even more important. Even in cases where there is no private benefit from efforts to preserve the civic asset--as is clearly the case under Mr. Kauffman's succession plan--the tax code is unclear in its treatment of charities that seek to preserve sports franchises in the community.

I am not personally familiar with the development of the federal tax code in this area. Perhaps its failure to allow a charity to help preserve a civic asset explicitly in the form of a sports franchise is one more of oversight than of forethought. It seems to me that Congress ought to encourage and foster activities that preserve civic assets while at the same time providing millions of dollars to charity. Mr. Chairman, that is exactly what this legislation would do.

You should be aware that the legislation does not in any way indicate that a baseball team can be operated on a tax-exempt basis--even though operas, museums, etc. can be. We're merely saying that activities to preserve a sports franchise or other such civic assets in a community should be permissible for a community trust.

This legislation is of the utmost importance to my hometown. It is a straightforward proposal that has been carefully crafted to involve the entire community, and the community has responded with its support. We spend a lot of time around here talking about the importance of restoring a sense of community in our society, of encouraging selfless, charitable work on behalf of others. Mr. Kauffman lived by that creed. With this legislation, we too have the opportunity to live by that creed and make it a reality.

It is difficult to imagine Kansas City without the Royals, and I believe most of my constituents feel the same way. Mr. Chairman, I am a proud member of this body, and I am proud of much of what the Congress has accomplished. Still, the public if often skeptical of the work we do here, and all too often we have acted to deepen that skepticism.

My constituents are no exception to this trend. Still, they want us to succeed, they want to help their own community, they want us all to work together to do what's right.

With your help, I hope we can do what's right.

I hope that this committee will act on the legislation favorably and as expeditiously as possible.

Once again, Mr. Chairman, I appreciate the opportunity to testify today.

Mr. McNulty. Thank you.

Any successful business activity arguably provides services to a community and enhances the economic well-being of the community. Why should the particular activities defined in this proposal as civic assets receive more favorable tax treatment than other business activities?

Mr. Wheat. Mr. Chairman, I think it is very clear in our society that major league sports while they are not charitable entities enjoy a place that is exalted above many others in terms of business. The Kansas City Royals baseball team is not just a private business asset that was held by one person in Kansas City for a very long time. It is a community asset, a part of the very fabric of our society and the entire community, in fact the entire Midwestern area—because there is not another baseball team within 250 miles of Kansas City—would suffer a great loss if this team were to leave.

The timing is extraordinarily bad in terms of the economics that would almost require the team to leave unless this succession plan were approved. Major league baseball does not have a commissioner currently. They are working on a number financing plans, including the possibility of a salary cap for major league baseball and most major league baseball teams make their profit based on television revenue.

If George Steinbrenner has set up this succession plan, it wouldn't be a problem for New York. They would be able to continue to operate the team strictly based on the TV revenues of New York City. We cannot do that in Kansas City. Even though we draw more than 2 million people a year, the TV revenues are so small from the team continues to lose money.

Mr. Kauffman was able to bear those losses personally while he was alive and it was not a major problem. He has in fact donated a significant amount of cash in addition to the baseball team in order to cover operating losses and a number of other community entities have donated millions of dollars for the purpose of covering the operating losses of the baseball team. But unless we clarify whether the charitable entity can hold the team for a period of time instead of being forced to sell it because of the operating losses, this generous succession plan will not be able to go into effect.

I would remind you that there is no loss to the Federal Treasury from the plan. It is a matter of whether the charitable entity can keep the baseball team for a time until ultimately it is sold to a private owner, hopefully one in the greater Kansas City area.

Mr. McNulty. I presume that you are aware that the proposal does confer a retroactive tax benefit and also the overall revenue impact——

Mr. Wheat. Mr. Chairman, we had tried to deal with this matter earlier this year once it became clear that Mr. Kauffman was gravely ill, and obviously more ill than anyone had realized prior to that time. We were not able to get this matter considered in the reconciliation bill, and I imagine it probably was not appropriate to consider it in the reconciliation bill. We ask for the retroactive tax status to be applied to the donation of the Kansas City Royals.

I would point out to you that in other areas of the tax law, retroactivity is not seen to be a major problem, especially when people were on notice that the action was likely to occur. In this situation, there would be no loss of any dollars to anyone as a result of the application of the retroactive status.

Mr. McNulty. With regard to the revenue impact generally, I presume you are also aware that the impact is fairly significant. I was wondering if you had thought about any possible offsets for it?

Mr. Wheat. The impact is significant in terms of the future of the baseball team, but we believe that there is no impact to the Federal Treasury in this specific circumstance because there are two options that are available here. One, the team can be donated to the community trust and the community trust can hold the baseball team until such time as it is sold to a private donor.

In the alternative, the team will be donated to the Kauffman Foundation, a private charitable organization that already exists, and because of the current law that private charitable foundation will then be forced to sell the team immediately and the team will likely be sold to someone outside of Kansas City.

In either case, whether it is donated to the community trust and held for the community or donated to the charitable trust and then sold immediately, there will be no revenue impact to the Federal Government.

Mr. McNulty. I presume that you have not yet received a letter on the revenue impact from the joint committee?

Mr. Wheat. No. We have been requesting that revenue impact, the letter that would officially verify what I have indicated to you in regard to the revenue impact, but we have not yet received it.

Mr. McNulty. I think that will be coming to you shortly and then I think that we should have further discussions.

Mr. Wheat. Mr. Chairman, I would be very happy to continue to work with this committee in order to facilitate the passage of this legislation or whatever legislation you believe is appropriate to help accomplish the goals that we have set out.

Mr. McNulty. I thank my colleague.

Mr. Hancock.

Mr. Wheat. Mel, I want you to know this is your baseball team, too.

Mr. Hancock. I am very interested in this situation. I appreciate your bringing it to the attention of the committee and taking your time to work on it.

I am familiar with what Ewing Kauffman did in Kansas City, not only in Kansas City, but in his entire life as far as charitable-type work.

I have a couple of questions. This charity that you are going to set up, the Kansas City Community Foundation—are you considering setting up a completely separate organization to accept the stock?

Mr. Wheat. No. This is a community trust fund that already exists. It is a major charity within the greater Kansas City area that has agreed to accept the donation of the Kansas City Royals baseball club under certain conditions and obviously those conditions include either new legislation or an IRS ruling that would determine that they could hold the team for a period of time.

Mr. HANCOCK. But this is just a standard; in other words, the Kansas City Community Foundation is already in existence?

Mr. WHEAT. Definitely.

Mr. HANCOCK. It is the same type of community foundation that individuals can set up self-directed charitable trusts and that type of thing?

Mr. WHEAT. I would not comment on other kinds of trusts that could be set up by individuals. This is a major trust that has been operated in Kansas City for many, many years. Someone might contradict me, but I believe it is probably the single largest charity within the greater Kansas City area.

Mr. HANCOCK. Isn't it an organization that individuals can set up trusts within that——

Mr. WHEAT. Yes; definitely.

Mr. HANCOCK. In other words, it is a standard community foundation-type operation?

Mr. WHEAT. Yes.

Mr. HANCOCK. I hope you won't mind if I become kind of a devil's advocate, because I think these questions need to be asked. Would this be a major change to allow any charity to operate an ongoing for-profit business? We are talking here about making an exception under the circumstances? The Kansas City baseball team is an asset of the city more than it is a personal asset of Ewing Kauffman. He lost money on it.

Mr. WHEAT. That is correct. On a continual basis.

Mr. HANCOCK. And the citizens of Kansas City actually benefitted from that team being in Kansas City?

Mr. WHEAT. Not only the psychic rewards of owning the baseball team, but it is a major economic factor within Kansas City. The citizens built a stadium for the Kansas City Royals baseball club and when there was turmoil surrounding the stadium situation in other cities where the teams were losing money, the relationship between Mr. Kauffman and the city of Kansas City and Jackson County, Mo., have always been strong.

There was never hint or suggestion that our team would leave even though the team lost money perpetually, and it has always been operated as if it were a community asset rather than the private asset of Mr. Kauffman.

Mr. HANCOCK. Needless to say, I am interested in keeping the Royals in Kansas City. I am looking forward to the year maybe that we can get the activity in the State of Missouri where the Cardinals and the Royals are in the World Series again. That was a major benefit to the economy of the State of Missouri.

As I understand the terms of this sale of the stock, and I have read the details here, there would be various classes of stock, class A, class B, and there would be a designated operator to operate the franchise itself. I understand that it would be required to sell the team, to find a buyer within 8 years.

Mr. WHEAT. That is correct.

Mr. HANCOCK. Or are they allowed to take 8 years?

Mr. WHEAT. They would be allowed to take up to 8 years in order to find a buyer. If in fact they could not find a local buyer, private buyer within the 8 years, then they would sell it to the highest bidder and it is likely that ultimately if no Kansas City owner were found, the team would be sold to a bidder outside Kansas City and it would leave the Kansas City area. All the profits would go to the charitable trust for use within the greater Kansas City area continuing, so the charity would receive the profits of the sale just as Mr. Kauffman intends.

If this committee or the IRS does not approve this request, the Kauffman Foundation will receive the profits of the sale of the baseball team at this point in time.

Mr. HANCOCK. But I understood you were attempting to restrict the transfer of the baseball team.

Mr. WHEAT. During the 8-year period of time when the community trust would own the baseball team, it could only be sold to someone who would agree to maintain the team within the greater Kansas City area.

Mr. HANCOCK. What happens when the 8 years expires?

Mr. WHEAT. Then the team would be required to be sold to the highest bidder wherever that bidder were from. We are asking for a period of time to seek out a local buyer, not to perpetually avoid having to sell the team or put the team on the open market.

Kansas City is a small market team and there are very few people with assets and resources of a Ewing Kauffman. We are hoping that over the next 8 years someone will come forward and be able to operate the team in largely the same manner that Mr. Kauffman did. I should also add that while major league baseball has a predisposition to having a single-owner situation, they have been continually apprised of Mr. Kauffman's succession plan. The management committee has met. They have talked about this plan. They have encouraged us to go forward, and I believe they will be supportive of this plan if this committee approves it.

Mr. HANCOCK. Thank you very much. I appreciate the work you are doing on this.

Thank you.

Mr. MCNULTY. Thank you, Mel.

If there are no further questions, we thank our colleague and congratulate him and Mr. Hancock also on the success of the Chiefs last night.

Thank you very much.

Mr. WHEAT. Thank you.

Mr. MCNULTY. I would also like to welcome our colleague Mr. Kleczka to the panel.

At this time, we will proceed to the Department of the Treasury, Hon. Leslie B. Samuels, Assistant Secretary for Tax Policy, and a frequent guest before this panel.

Your statement will appear in the record in its entirety and you may proceed to summarize in any way you see fit.

STATEMENT OF HON. LESLIE B. SAMUELS, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. SAMUELS. Mr. Chairman and members of the subcommittee, I am pleased to present the views of the administration on the miscellaneous revenue proposals that are the subject of this hearing. I plan to briefly summarize my testimony.

These hearings are a continuation of a series of public hearings which began in June 1993 relating to miscellaneous revenue proposals submitted by members of the Committee on Ways and Means. We testified on the first group of over 170 miscellaneous tax proposals on June 22, 1993. The subcommittee has before it today over 80 proposals covering a broad range of topics. In the process of considering these proposals, we believe that it is important to keep in mind that Congress has recently enacted and the President has signed a major piece of tax legislation, the Omnibus Budget Reconciliation Act of 1993, so-called OBRA 1993. We would urge the subcommittee in its deliberations on miscellaneous revenue proposals to consider the importance of stability in the tax law. An argument can be made that additional changes to the Internal Revenue Code should be minimized for a period of time sufficient to allow the government as well as taxpayers and their advisors to absorb the significant changes just made in OBRA 1993. Furthermore, we recognize that any tax bill that moves through Congress prior to the end of this year could become a vehicle for numerous amendments. Although many of those proposals could be meritorious, collectively they could result in further instability in our tax laws.

We have taken a position on most of the proposals under consideration today. However, we have not taken a position with respect to proposals that are currently under study or those that we believe should be considered in the context of comprehensive health care reform.

In developing our views on revenue-raising proposals, we have relied, as we did during the budget reconciliation process and in our June 22, 1993 testimony, on a number of tax policy principles and goals. These principles and goals are stated in the written testimony. I would like to note in this regard that we generally oppose any proposals that have the effect of reversing policy decisions made in OBRA 1993. We have however identified several technical corrections to that legislation and would like to encourage members of the subcommittee to aid us in our attempt to ensure the implementation of congressional intent.

Finally, we understand that the subcommittee is also interested in the tax simplification proposals and technical corrections included in H.R. 13 and H.R. 17. While we generally support these proposals and recognize the importance of simplifying the tax law and providing technical corrections, we would like to work with the subcommittee to suggest technical modifications and to identify areas in which we have policy concerns.

That concludes my summary and I would be pleased to answer any questions.

[The prepared statement follows:]

For Release Upon Delivery
Expected at 10:00 a.m.
September 21, 1993

STATEMENT OF
LESLIE B. SAMUELS
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES OF THE HOUSE COMMITTEE ON WAYS AND MEANS

Mr. Chairman and Members of the Subcommittee:

I am pleased to present the views of the Administration on the miscellaneous revenue proposals that are the subject of this hearing. These proposals are described in the September 16, 1993 pamphlet prepared by the staff of the Joint Committee on Taxation (JCT Pamphlet).[1]

These hearings are a continuation of a series of public hearings, which began in June 1993, relating to miscellaneous revenue proposals submitted by Members of the Committee on Ways and Means. We testified on the first group of over 170 miscellaneous tax proposals on June 22, 1993.[2] The Subcommittee has before it today over 80 proposals covering a broad range of topics. They deal with issues relating to individual taxation, excise taxes, tax-exempt entities, tax accounting, compliance, and numerous other areas. Some of the proposals are narrowly drawn, while others represent significant changes to current law.

Many of the proposals that are the subject of today's hearing have been proposed as revenue-raising offsets to the provisions we addressed on June 22. In our previous testimony we stated that the Administration's views concerning those proposals and the revenue losing proposals considered today assume that appropriate offsetting revenue measures would be proposed. As we stated at that hearing, and reiterate today, we want to work with the Subcommittee, and the Congress as a whole, to set priorities for the use of any acceptable revenue offsets that may be identified.

In the process of considering these proposals, we believe that it is important to keep in mind that the Congress has recently enacted, and the President signed, the most significant deficit reduction legislation in the history of our Nation. The Omnibus Budget and Reconciliation Act of 1993 (OBRA '93) included significant changes in the tax law. It raised the tax burden for some while lowering the burden for others, all with a view toward meaningful deficit reduction and improving the overall fairness of the tax system. We would urge the Subcommittee in its deliberations on the miscellaneous revenue proposals to consider the importance of stability in the tax law. An argument can be made that additional changes to the Internal Revenue Code (Code) should be minimized for a period of time sufficient to allow taxpayers and their advisers to absorb the significant changes that have just been made in OBRA '93. Furthermore, we recognize that any tax bill that moves through Congress prior to the end of this year could become the vehicle for numerous amendments.

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[1] Joint Committee on Taxation, Description of Miscellaneous Revenue Proposals (JCS-12-93), September 16, 1993.

[2] A number of the items on which we testified on June 22, 1993 are included in the JCT Pamphlet. In this testimony we do not repeat positions that were provided in our June 22, 1993 testimony. In addition, we do not address the proposals relating to the health benefits of retired coal miners, on which we presented testimony to the Ways and Means Committee on September 9, 1993.

Although many of those proposals could be meritorious, collectively they could result in further instability in our tax laws.

We have taken a position on most of the proposals under consideration today. However, we have not taken a position with respect to proposals that are currently under study or those that we believe should be considered in the context of comprehensive health care reform.

In developing our views on revenue raising proposals, we have relied, as we did during the budget reconciliation process and in our June 22, 1993 testimony, on a number of tax policy principles and goals. These principles and goals continue to include deficit reduction; economic growth; equitable treatment of taxpayers; simplification within the constraints of deficit reduction; and improved compliance and enforcement of our tax laws. In addition, our ultimate position on each of the revenue-raising proposals under consideration will depend upon the intended use of the revenue raised and upon whether the bill as a whole is consistent with these principles and goals. Moreover, we generally oppose any proposals that have the effect of reversing policy decisions made in OBRA '93. We have, however, identified several technical corrections to that legislation and would like to encourage Members of the Subcommittee to aid us in our attempt to ensure the implementation of Congressional intent.

Finally, we understand that the Subcommittee also is interested in the tax simplification proposals and technical corrections included in H.R.13 and H.R.17. While we generally support these proposals, and recognize the importance of simplifying the tax law and providing technical corrections, we would like to work with the Subcommittee to suggest technical modifications and to identify areas in which we have policy concerns.

The remainder of my written statement is a detailed discussion of the Administration's positions on the miscellaneous revenue proposals that are the subject of this hearing. The discussion follows the order of the proposals described in the JCT Pamphlet.

I. MISCELLANEOUS REVENUE PROPOSALS

A. ALTERNATIVE MINIMUM TAX

1. Use of the 200-percent Declining Balance Depreciation Method for Automobiles for Alternative Minimum Tax Purposes.

Administration position. **Do not support.** Congress recently determined, in OBRA '93, that the use of the 150% declining balance method was an appropriate method of depreciation for alternative minimum tax purposes. In light of this recent change of law, it is inappropriate at this time to change the method of depreciation for alternative minimum tax purposes, particularly for a single class of property.

B. FINANCIAL INSTITUTIONS

1. Deductibility of Bad Debt Losses of Nonbank Lending Institutions.

Administration position. Proposal addressed in the June 22, 1993 testimony.

C. INSURANCE

1. Extension of Tax and Loss Bond Treatment Applicable to all Types of Financial Guaranty Insurance.

Administration position. This proposal does not raise a significant federal income tax issue, but instead relates primarily to regulatory matters. Because a company that claims a deduction under section 832(e) must purchase noninterest-bearing federal government bonds equal to the amount of the tax savings attributable to the deduction, the amount that the company pays the government in a given year is the same regardless of whether it claims the deduction. The principal effect of the provision is to allow the company to report an asset for regulatory purposes as a result of the payment.

2. Treatment of Policy Acquisition Expenses Related to Certain Accident and Health Insurance.

Administration position. **Do not support.** Present law requires that insurance companies capitalize prescribed percentages of net premiums for three categories of insurance contracts as a surrogate for determining the facts and circumstances of actual policy acquisition costs. Should Congress decide that current law results in an excessive deferral of acquisition expenses and consider lowering the statutory percentage for a type of insurance, it may wish to consider whether acquisition costs are understated for other types of insurance and make corresponding adjustments to the percentages for those types of insurance. Moreover, we note that the Secretary of the Treasury is authorized to provide that a specified type of contract is treated as a separate category and prescribe a percentage for that category if present law results in substantially greater deferral of acquisition expenses than would capitalization of actual expenses. If he exercises this authority, the Secretary is required to adjust the percentages for remaining categories of insurance contracts to avoid a revenue loss.

D. EMPLOYEE BENEFITS

1. Tax-Credit Employee Stock Ownership Plans (ESOPs).

Administration position. **Do not support.** We do not believe that it is appropriate at this time to expand the tax benefits for ESOPs. Current law already provides incentives for employers that desire to compensate their employees through an ESOP. In addition, we do not believe that it is consistent with broader retirement policy goals to increase the level of tax subsidy for ESOPs in comparison to other types of retirement plans that provide more diversified savings for employees.

2. Permit ESOPs to Prohibit Rollover of In-Service Distributions.

Administration position. **Do not support.** Some employers are concerned that employees will take in-service distributions from ESOPs in order to reinvest the amounts in their own individual retirement accounts (IRA), rather than the employer plan. However, general expansion of the rollover rules has been beneficial to employees and the retirement system as a whole, in part by encouraging employees to invest their distributions in an IRA rather than spend them. In the context of encouraging these goals, it would be a step backwards to exclude these in-service withdrawals from the definition of eligible rollover distributions.

3. Rollover of Certain Separation Payments.

Administration position. **Do not support.** We do not believe that it is generally appropriate to expand the individual retirement account rollover provisions to distributions that have not been dedicated to retirement savings under a tax-qualified plan. In addition, we are concerned that the proposal may result in substantial revenue loss.

E. INDIVIDUAL INCOME TAX

1. Increase Eligible Income Level for Performing Artist Employee Exemption from the Limitation on Deduction for Unreimbursed Business Expenses.

Administration position. **Do not support.** Present law provides a deduction in computing adjusted gross income (and thereby also an exemption from the 2-percent floor on miscellaneous itemized deductions) for a limited class of low-income performing artists. We are unaware of any justification for expanding this relief by more than doubling the income limitation. Doing so would represent an erosion of the policies underlying the calculation of adjusted gross income and the establishment of the 2-percent floor on miscellaneous itemized deductions.

2. Waiver of Statute of Limitations Relating to Certain Severance Payments.

Administration position. **Do not support.** Statutes of limitation provide both taxpayers and the government with certainty that disputes will not arise concerning events in the distant past, and, thus, as a general matter, should not be waived on a selective basis.

F. TAX-EXEMPT BONDS

1. Certain Airport, Dock, and Wharf Facilities.

Administration position. Proposal addressed in the June 22, 1993 testimony.

G. TAX-EXEMPT ENTITIES

1. Permit a Qualified Scholarship Funding Corporation to Transfer Assets and Debts to a For-Profit Corporation Without Causing Tax-Exempt Bond Interest to be Taxable.

Administration position. **Do not support.** It appears that the proposal would enable taxable, for-profit corporations to obtain the benefit of tax-exempt financing. The benefit is equal to the built-in arbitrage of the difference between the tax-exempt interest rates on the debt issued by the qualified scholarship funding corporations and comparable taxable interest rates. For-profit entities should not be entitled to such arbitrage. The proposal also creates an exception to the excess business holdings rule. The excess business holdings rule was specifically created to prevent private foundations from controlling for-profit entities.

2. Provide Favorable Tax Treatment for Preservation of Civic Assets by Community Trusts.

Administration position. **Do not support.** There is no apparent justification for special rules that provide more favorable tax treatment to the preservation of a civic asset than the treatment provided by current law.

H. EMPLOYMENT TAXES

1. Eliminate Statutory Rule for Bakery Distributors.

Administration position. Proposal addressed in the June 22, 1993 testimony.

2. Treat State Universities and Agency Accounts as Related Corporations for FICA Tax Purposes.

Administration position. Proposal addressed in the June 22, 1993 testimony.

3. Exempt Certain Religious Schools from Federal Unemployment Tax.

Administration position. Proposal addressed in the June 22, 1993 testimony.

I. OTHER PROVISIONS

1. Enhanced Deduction for Contributions of Computer Equipment to Arts Institutions.

Administration position. Proposal addressed in the June 22, 1993 testimony.

2. Require Treasury to Issue Certificates Evidencing Obligations of the United States Held by the Social Security Trust Funds.

Administration position. **Oppose.** The Treasury Department and administrators of the Social Security Trust Funds already have detailed records that delineate the amounts and kinds of obligations held by the fund. Issuing certificates to this effect would increase administrative costs and provide no additional benefit to beneficiaries.

3. Limit Applicability of Generation-Skipping Transfer Tax.

Administration position. **Do not oppose.** The policies that underlie the special rule for transfers to grandchildren (Code section 2612(c)(2)) generally would support the proposed expansions to cover collateral heirs and to apply the rule to taxable terminations and taxable distributions as well as direct skips.

II. MISCELLANEOUS REVENUE-RAISING PROPOSALS

A. ALTERNATIVE MINIMUM TAX

1. Increase the Alternative Minimum Tax Recovery Period for Assets Used in Manufacture of Tobacco Products.

Administration position. The Administration is currently preparing a comprehensive health care reform package that may include changes in the tax treatment of tobacco products. Any tax issues relating to tobacco products and businesses producing tobacco products should be addressed in the context of health care reform.

2. Lengthen Alternative Minimum Tax Recovery Period for Coal Mining Equipment.

Administration position. **Do not support.** Congress recently considered, in OBRA '93, modifications to the alternative minimum tax depreciation system, and concluded that the use of the 150% declining balance method over a 10 year period was an appropriate method of depreciation for alternative minimum tax purposes. In light of this recent determination, and absent economic analysis supporting a change, it is inappropriate at this time to change the alternative minimum tax class life for a particular class of property.

3. Lengthen the Alternative Minimum Tax Amortization Period for Coal Mining Exploration and Development Costs.

Administration position. **Do not support.** Congress recently considered, in OBRA '93, modifications to the alternative minimum tax depreciation system, and did not alter the recovery period with respect to mining exploration and development costs. In light of this recent legislation, and absent economic analysis supporting a change, it is inappropriate at this time to change the alternative minimum tax recovery period for a particular type of mining and development costs.

B. ACCOUNTING

1. Change the Five-Year Maturity Date Requirement to Four Years for High Yield Discount Obligations.

Administration position. **Do not support.** The high-yield discount rules are complex and should not be expanded on a piecemeal basis. Moreover, relatively short-term obligations do not raise to the same degree the policy concerns that motivated the original high-yield discount rules (i.e., the ability to deduct equity-like returns with payments deferred until some future date).

2. Require Organizational Expenses to Be Amortized Over an Extended Period.

Administration position. **Do not support.** Under current law, the organizational expenses of corporations and partnerships are both amortizable over a period of 60 months. It is desirable that the treatment of the organizational expenses of both types of entities remain similar. While the existing 60-month period can be viewed as a relatively arbitrary period, any change in the period should be made after a review of whether a longer period can be justified, on the basis of economic and related facts and circumstances, as more appropriate.

3. Require Portion of Advertising Expenses to be Capitalized and Amortized.

Administration position. **Oppose.** We believe that advertising expenses typically are not directly associated with the creation of a benefit extending beyond the current year, and consequently generally should be currently deductible. Thus, this proposal can be viewed as an arbitrary deferral of an ordinary and necessary business expense.

C. FINANCIAL INSTITUTIONS

1. Immediate Recognition of Points Paid to Mortgage Lenders.

Administration position. **Oppose.** When a lender simultaneously makes a loan and receives points paid by the borrower, the net economic effect is the making of a loan at a discount (e.g., a transaction involving a $100,000 loan and a payment of 3 points, or $3,000, represents a loan of $97,000 with $100,000 payable at maturity). We believe that the appropriate treatment of this discount is provided under the original issue discount provisions of the Code (i.e., the discount must be taken into income by the lender over the term of the loan on a constant yield-to-maturity basis). Therefore, we oppose this proposal, which would, in effect, treat the loan and the payment of points as two separate transactions.

2. Bad Debt Reserve Deduction for Thrifts.

Administration position. **Support.** We agree with the proposed rule, which we believe generally follows current law. Our only concern is that the proposal be crafted so as not to create negative implications concerning the treatment of net operating losses incurred before the effective date.

D. COST RECOVERY

1. Lengthen Recovery Period for Water Utility Property.

Administration position. **Do not support.** Changes in the depreciable life of particular categories of property should be made only after a detailed evaluation of the relevant economic and related facts and circumstances. The Administration is not aware of any information or analysis justifying a longer recovery period for water utility property.

2. Increase Regular Tax Recovery Period for Certain Assets Used in Printing and Publishing.

Administration position. **Do not support.** Changes in the depreciable life of particular categories of property should be made only after a detailed evaluation of the relevant economic and related facts and circumstances. The Administration is not aware of any information or analysis justifying a longer recovery period for assets used in printing and publishing.

E. PASS-THROUGH ENTITIES

1. Clarification of Rules Relating to the Timing of the Flow-Through of Income to Estates that Own Interests in Partnerships and S Corporations.

Administration position. **Support.** The proposal requires that partnership and S corporation items be allocated to an estate for the period of time the interest is held by the estate. Thus, this proposal would make the rules for estates similar to those applicable to individuals.

2. Repeal the Taxable Income Limitation on the Recognition of Built-in Gain of S Corporations.

Administration position. **Do not support.** The taxable income limitation under Code section 1374 prevents S corporations from paying a built-in gains tax on amounts greater than their taxable income. As a result, the effect of the built-in gains tax is spread to periods where the S corporation has taxable income. Repeal of the limitation would make some corporations worse off as S corporations than they would have been if they had remained C corporations. If significant changes, such as this proposal and other proposals discussed in our testimony on June 22, 1993 are to be made to the S corporation regime, the proposals should be fashioned pursuant to a comprehensive deliberate process, rather than on a piecemeal basis.

F. INDIVIDUAL INCOME TAX

1. Denial of Certain Travel-Away-from-Home Expenses.

Administration position. **Do not support.** This proposal would deny deductions for a particular class of ordinary and necessary expenses incurred in generating income from rental property, while income from such property would remain fully taxable. If substantial abuse involving these types of travel expenses is found, then legislative changes might be necessary.

2. Computation of Standard Mileage Rate.

Administration position. **Do not support.** We are unaware of evidence that the current procedure used by the Internal Revenue Service (IRS) to determine the standard mileage rate overstates the costs of operating a vehicle. Prescribing an unduly low standard mileage rate would encourage more taxpayers to deduct their actual costs, resulting in increased administrative burdens for both the taxpayers and the IRS of the type that the standard mileage rate was intended to avoid.

3. Limit the Deduction For Business Transportation Expense.

Administration position. **Do not support.** This provision would create considerable administrative burdens and in many cases would impose an arbitrary restriction on the deduction of an ordinary and necessary business expenses.

4. Repeal Special Rules for Certain Rental Use.

Administration position. **Do not oppose.** Taxpayers should be subject to tax on income received with respect to the rental of a residence without regard to the period of such rental. The repeal of the current law de minimis provision should not impose an undue administrative burden on the affected taxpayers.

5. Limit the Deduction of Wagering Losses.

Administration position. **Do not support.** Wagering losses have been considered deductible only to the extent of wagering gains since 1934. The income tax system should generally allow for deductions of expenditures made in generating income. Allowing wagering losses to offset only 80 percent of wagering gains is an arbitrary reduction of this otherwise deductible expenditure.

6. Limit Airfare Deductions to Coach Fare if Coach is Available.

Administration position. **Oppose.** Imposing a new limitation on the deductibility of airline fares would create significant administrative burdens. In addition, it would be inappropriate to single out the airline industry in contrast to other forms of transportation by limiting deductions for airfare to a particular fare.

7. Increase the Threshold for the Deduction of Casualty Losses from $100 to $500.

Administration position. **Do not support.** Since 1982 the 10 percent of adjusted gross income threshold, rather than the $100 threshold, has been the primary limitation on the availability of the deduction. This proposal would have the effect of reducing a taxpayer's otherwise allowable casualty loss deductions by $400 per casualty.

G. NATURAL RESOURCES

1. Impose Severance Tax on Hard Rock Minerals.

Administration position. **Issue under study.** The Department of Interior has been studying the economic implications of a royalty system for hardrock minerals on federal lands. Upon completion of the Administration's evaluation, the Administration will consult with Congress regarding what actions are appropriate.

2. Increase Tariff on Imported Oil and Petroleum Products.

Administration position. **Issue under study.** The Department of Energy Task Force on National Energy Initiatives is studying policies that affect production of natural energy resources. Upon completion of the Administration's review of the findings of that study, the Administration will consult with Congress regarding what actions are appropriate.

H. FOREIGN TAX PROVISIONS

1. Modification of the Sales Source Rules.

Administration position. **Do not support.** The proposals to amend the rules for sourcing income from the sale of inventory property may raise significant technical question and administrative concerns in a number of cases.

2. Increase Tax on Gross Transportation Income.

Administration position. **Oppose.** By agreement, or otherwise, residents of over 60 countries (including all major shipping countries) have an exemption from this tax. The proposed tax increase, therefore, would fall disproportionately on the shipping companies of smaller developing countries with which the United States does not have agreements.

3. Repeal Portfolio Interest Exemption.

Administration position. **Oppose.** Repeal of the portfolio interest exemption would substantially increase the borrowing costs of the U.S. Government and U.S. corporations. In order to remain competitive in international financial markets, U.S. Government and corporate debt would have to compensate foreign lenders for the effect of a 30% U.S. withholding tax through higher interest rates. U.S. borrowers who could not afford to "gross up" foreign lenders would be unable to borrow abroad, resulting in increased competition for U.S. capital and a corresponding increase in domestic interest rates.

4. Change Foreign Tax Credit to a Deduction.

Administration position. **Oppose.** The foreign tax credit protects U.S. taxpayers from double taxation of income that is earned outside the U.S. A deduction for foreign taxes would not effectively avoid double taxation. Without the foreign tax credit there would be a penalty for conducting business abroad rather than in the U.S. even though non-tax considerations might favor the foreign location. Elimination of the credit also would unilaterally override our treaty obligations and could lead to retaliation by other countries. If foreign countries were to repeal their credit for U.S. income taxes, there would be a bias against investment in the U.S. by those countries' nationals.

5. Excise Tax on Certain Insurance Premiums Paid to Foreign Persons.

Administration position. **Oppose.** We do not believe that the necessity for a general increase at this time in the rate of the tax has been demonstrated. In addition, we understand that this provision may have implications for U.S. efforts to reduce foreign trade barriers to U.S. insurers that the Committee may wish to weigh in considering the issue of competitiveness. We do not oppose, however, efforts to facilitate collection of the federal insurance premiums tax now imposed by the Code on the reinsurance of U.S. risks from one foreign insurer to another. However, we oppose this proposal because we do not believe it can be administered fairly and effectively. For example, we are seriously concerned about the burden of negotiating and monitoring the hundreds of closing agreements that would be required and about the difficulty of determining the effective rate of foreign tax in a multitude of countries. In any event, the proposal should be amended to take into account any current U.S. taxation of United States shareholders under subpart F of the Code.

6. Taxation of a Tax-Exempt U.S. Shareholder on Subpart F Unrelated Business Taxable Income (UBTI).

Administration position. **Oppose.** We understand that the target of this proposal is the offshore captive insurance industry. If there is a perception that offshore captives are engaging in abuse, a proposal that focuses more narrowly on that concern should be developed. The proposal is also overbroad in that it applies to all categories of subpart F income and because it applies to a tax-exempt shareholder owning as little as 10% of a foreign corporation's stock, a level of investment that is closer to the type of portfolio investment that historically has generated passive, non-UBTI. Because the proposal is based upon subpart F, which applies at the shareholder level, it addresses UBTI in a fundamentally different way than it is addressed in a purely domestic context. In the domestic context, UBTI is not taxed at the shareholder level and the unrelated business income tax rules have not generally sought to equalize the cost of capital as between tax-exempt and taxable ownership. Finally, the proposal inappropriately uses subpart F, which is a timing provision, to effectively impose a tax that the tax-exempt shareholder otherwise would not pay.

I. EXCISE TAXES

1. Increase in Wagering Excise Tax.

Administration position. **Do not support.** It is unclear whether an increase in the existing wagering excise tax would promote appropriate policy goals. Any proposal to increase the rate of tax should be considered, if at all, as part of a comprehensive review of the purpose and design of the tax.

2. Excise Tax on Foreign-Controlled Corporations.

Administration position. **Oppose.** The proposal would impose an excise tax on purchases by a foreign controlled corporation from foreign related parties unless the foreign controlled corporation consents in writing to provide the information described in Code section 6038A. Section 6038A does not require "consent" to provide information. To the contrary, the statute and the regulations require that the described information be provided annually on a Form 5472 that is filed with the taxpayer's tax return. Moreover, the substantial penalties, including monetary penalties and disallowance of deductions for goods transferred between related parties, already may be imposed on taxpayers that fail to provide the required information. Given these substantial penalties, compliance with section 6038A has not been considered a problem, and an additional 5 percent penalty is unlikely to improve further compliance with section 6038A.

3. Increase Excise Tax on Prohibited Transactions.

Administration position. **Do not support.** We believe that current law adequately deters prohibited transactions. The 5-percent tax under Code section 4975 is cumulative and can result in significant penalties. In addition, if a taxpayer does not correct the prohibited transaction prior to an assessment of the 5-percent tax, the taxpayer can be assessed with a 100-percent penalty. A prohibited transaction also may result in civil penalties and lawsuits by plan participants or the Department of Labor.

4. Increase Tobacco Excise Taxes.

Administration position. The Administration is currently preparing a comprehensive health care reform package that may include changes in the tax treatment of tobacco products. Any tax issues relating to tobacco products should be addressed in the context of health care reform.

5. Extend Communications Excise Tax to Cable Television.

Administration position. **Do not support.** While there are many types of communications services and options available today, the communications excise tax applies primarily to telephone service. Any proposed expansion of the communications excise tax should be considered, if at all, as part of a comprehensive review of the purpose and design of the tax.

6. Repeal Exemption from Communications Excise Tax for News Services.

Administration position. **Do not support.** News service organizations have one of a number of specific exemptions from the communications excise tax. Any proposed expansion of the communications excise tax should be considered, if at all, as part of a comprehensive review of the purpose and design of the tax and of the role of the exemption for news service organizations and the changes that are occurring in the communications industry.

7. Excise Tax on Carbon Dioxide Sold by Ethanol Producers.

Administration position. **Do not support.** The imposition and collection of this new tax would impose substantial complexities and administrative costs.

8. Increase Excise Tax on Heavy Trucks.

Administration position. **Do not support.** We are unaware of any justification for an increase in the heavy truck excise tax at this time.

9. Expand Ozone-Depleting Chemicals Excise Tax.

Administration position. **Do not oppose.** The 1992 Copenhagen amendment to the Montreal Protocol freezes industrialized country consumption of methyl bromide at 1991 levels and phases out industrialized country consumption of hydrochlorofluorocarbons (HCFCs) and hydrobromofluorocarbons (HBFCs). Similarly, the Environmental Protection Agency has proposed listing methyl bromide and HBFCs as class I substances. Extending the tax to these chemicals would be consistent with the treatment of other chemicals controlled by the Montreal Protocol (all of which are currently taxed).

J. TAX-EXEMPT ENTITIES

1. Additional Restrictions on Discriminatory Social Clubs.

Administration position:

(a) Addition of gender discrimination to types of discrimination to which section 501(i) applies. **Do not support.** The issue of gender discrimination by social clubs deserves attention. We are concerned, however, that this particular proposal could deny tax exemption to certain organizations, such as women's clubs, fraternities, or sororities, that have long-standing and relatively noncontroversial practices of limiting membership on the basis of gender.

(b) Denial of tax exemption to a club found to have discriminated on prohibited grounds. **Support.** There is little justification for allowing a club to maintain exemption simply because its discriminatory practices are not pursuant to a written document. The requirement that the provision would apply in the case that there has been a final determination of discrimination by an appropriate government agency or court will facilitate administration of the provision.

(c) Denial of preferential tax treatment for tickets at events held at discriminatory clubs. **Do not oppose.** The federal tax laws should not provide preferential treatment to discriminatory clubs. We would note, however, that existing law already imposes a sanction on these clubs by denying them exemption from tax. Thus, denying the benefits of provisions such as section 274(l)(1)(B) for tickets to a charity sports event held at a discriminatory club may have little marginal impact on the club.

2. Taxation of Campaign Committees of Federal Candidates at the Highest Corporate Rate.

Administration position. **Do not oppose.** There is little tax policy justification for taxing the campaign committees of candidates for state and local offices at a higher rate than the rates applicable to committees of candidates for federal office. Requiring all campaign committees of candidates for federal office to compute their tax using the highest marginal corporate rate would be one means of eliminating this disparity.

3. Impose a 30-percent Excise Tax on Expenditures of Tax-Exempt Organizations for Lobbying.

Administration position. **Oppose.** OBRA '93 included a provision that denies deductions for the lobbying expenses, applicable to both businesses and contributors to tax-exempt organizations. In light of this recent change of law, it is inappropriate at this time to change the rules relating to the tax treatment of lobbying expenses.

4. Include Contacts with Regulatory Agencies in the Definition of Lobbying for Purposes of the Existing Restrictions on 501(c)(3) Organizations.

Administration position. **Oppose.** OBRA '93 included a provision that denies deductions for the lobbying expenses, applicable to both businesses and contributors to tax-exempt organizations and to lobbying of the Executive as well as Legislative branch of government. This provision includes a special rule to prevent businesses from lobbying through a section 501(c)(3) organization. In light of this recent change of law, it is inappropriate at this time to change these rules.

5. Extension of Private Inurement Rule to 501(c)(4) Organizations.

Administration position. We understand that this proposal is targeted to transactions involving the health services industry. As such, the Administration will consider it in the context of its comprehensive health care proposals. The Administration supports measures to ensure that the assets of a section 501(c)(4) organization are used in a manner that is consistent with the organization's exempt purpose. An amendment of section 501(c)(4) to include a prohibition against inurement, however, may not be the most appropriate means of achieving this goal. We will work with the Ways and Means Committee and its staff to develop appropriate measures.

K. COMPLIANCE

1. Information Reporting on State and Local Real Property Taxes and Refunds.

Administration position. **Do not oppose.** This proposal would make it easier for the IRS to verify whether certain claimed deductions for real estate taxes are accurate. Thus, it would improve the compliance with and enforcement of our tax laws. We are concerned, however, about the ability of local taxing jurisdictions to comply with this proposal. This concern should be addressed in the general design (e.g., administrative requirements, effective date, etc.) of the proposal.

2. Increase Individual Estimated Tax Payment Safe Harbor from 110 percent to 115 percent.

Administration position. **Oppose.** OBRA '93 included a provision that allowed taxpayers with adjusted gross income exceeding $150,000 in the preceding tax year to avoid estimated tax penalties for the current year by paying 110 percent of the previous year's tax liability in estimated tax payments (taxpayers with lower incomes may use a 100 percent of last year's liability safe harbor). In light of this recent change of law, it is inappropriate at this time to change the estimated tax rules for these individuals. In addition, we believe that the current 110 percent safe harbor strikes a fair balance between the government's need to have taxpayers pay income taxes during the tax year and taxpayers' desire to have a safe harbor that allows for simplification and certainty in calculating estimated tax payments.

3. Require Written Substantiation for any Meal and Entertainment Expense (or Alternatively for Amounts Over $10).

Administration position. **Oppose.** OBRA '93 included a provision that reduces the deduction for business meals and entertainment. In light of this recent change of law, it is inappropriate at this time to change the rules. In addition, the Treasury has the authority under the statute to determine the substantiation necessary for taxpayers to support and deduct meal and entertainment expenditures. The Treasury has also determined, by regulations, the threshold level of expenditure for which substantiation is not required. This threshold amount recognizes that it would be overly burdensome for taxpayers to keep detailed records for expenditures under this amount, which is currently $25 per expenditure.

4. Deny Corporations a Deduction for All or Part of Interest Paid on Federal Tax Underpayments.

Administration position. **Oppose.** Current law provides adequate incentives for corporate taxpayers to pay their taxes in a timely fashion. The increased rate of interest imposed on "large corporate underpayments" was enacted in 1990 in lieu of a provision that would have disallowed a deduction for interest paid on tax liabilities.

5. Increasing the Rate of Interest Imposed on Corporate Tax Deficiencies.

Administration position. **Oppose.** Current law provides adequate incentives for corporate taxpayers to pay their taxes in a timely fashion. The increased rate of interest imposed on "large corporate underpayments" was enacted in 1990 in lieu of a provision that would have disallowed a deduction for interest paid on tax liabilities. There is no evidence of any need to increase the rate of interest imposed on corporate underpayments.

6. Increase Rate of Interest for Underpayments of Estimated Tax for Certain Alaska Native Corporations (ANCs) and Persons.

Administration position. **Do not oppose.** In conjunction with the proposal to grant ANCs an election to obtain standing (discussed in our testimony presented to the Subcommittee on June 22, 1993), we do not oppose this proposal.

7. Information Reporting for Discharge of Indebtedness Income.

Administration position. **Do not support.** OBRA '93 included a provision that requires information reporting for discharge of indebtedness income. In light of this recent change of law, it may be inappropriate at this time to extend the scope of these rules unless such change is necessary to fulfill Congressional intent.

8. Increase Withholding on Bonuses from 28 percent to 36 percent.

Administration position. **Oppose.** OBRA '93 included a provision that increases the withholding tax rate on bonuses to 28 percent. In light of this recent change of law, it is inappropriate at this time to change these rules. In addition, a 36 percent withholding tax rate would result in overwithholding in many cases since the 36 percent income tax rate enacted in OBRA '93 applies to only 1.2 percent of the highest income taxpayers. Moreover, many employers are in the process of updating their accounting systems to allow a timely change to the new rules. A change in the law at this time could prove costly to these employers.

9. Increase in Rate of Withholding on Gambling Winnings.

Administration position. **Do not support.** A 36 percent withholding rate would result in overwithholding in many cases since the 36 percent tax rate enacted in OBRA '93 applies to only 1.2 percent of the highest income taxpayers.

10. Increase in Rate of Backup Withholding on Reportable Payments.

Administration position. **Do not support.** A 36 percent withholding rate would result in overwithholding in many cases since the 36 percent tax rate enacted in OBRA '93 applies to only 1.2 percent of the highest income taxpayers. Moreover, many businesses are in the process of updating their accounting systems to allow a timely change to the new rules. A change in the law at this time could prove costly to these businesses.

11. Information Reporting for Purchases of Fish.

Administration position. **Do not oppose.** We understand that a significant number of cash sales of fish are not included in income. This proposal would increase compliance.

12. Extension of IRS Offset Authority for Undercover Operations.

Administration position. **Support.** Reinstatement of the offset authority granted to the IRS in Code section 7608(c) is necessary to enable the IRS to continue undercover investigations in such areas as money laundering and the motor fuel excise tax. Therefore, the Administration has consistently supported permanent extension of this provision.

13. Disclosure of Returns on Cash Transactions.

Administration position. **Support.** The continued disclosure by the IRS, to other Federal agencies, of information returns filed under Code section 6050I improves the enforcement of federal criminal statutes.

L. MISCELLANEOUS ISSUES

1. Repeal of Classification Safe Harbor for Construction Industry Employees.

Administration position. **Do not support.** We believe that it would be preferable as a matter of tax policy to consider general modifications to section 530 of the Revenue Act of 1978 rather than adopting industry-specific rules.

2. Disallow Deductions for Compensatory Damages Under Certain Environmental Laws.

Administration position. **Oppose.** We believe that the current law distinction between compensatory payments that are deductible under Code section 162 and nondeductible fines and penalties should be maintained with respect to payments under environmental laws. Disallowing any deduction for such ordinary and necessary expenses may discourage taxpayers responsible for such damages from agreeing to make compensatory payments.

3. Restricting Like-Kind Exchanges.

Administration position. **Oppose.** The Administration is not persuaded that there is presently any need to revise the standard, based on the use of the property received in an exchange of like-kind property, for determining whether property exchanges qualify for tax deferral.

4. Disallowance of Stock Options as Qualified Research Expenses.

Administration position. **Do not oppose.** Qualified research expenditures should not include wages paid in the form of stock options to the extent that the wages exceed the amount anticipated at the time the employer decides to conduct the research.

5. Anti-Abuse Rules Applicable to the Rollover of Gain Under Section 1071.

Administration position. We would not oppose a carefully targeted amendment to Code section 1071 that would prevent certain sellers (e.g., those who actively participate in sham transactions) from taking advantage of the deferral provided by that section. However, the amendment should not deny the deferral to "innocent" sellers. To our knowledge, no specific proposal has been developed at this time. Thus, it would be premature for us to express a definitive position.

6. Amortize Environmental Remediation Costs Over a Period of Years.

Administration position. **Issue under study.** We are currently considering appropriate ways to reduce the potentially large costs likely to be incurred by the IRS and taxpayers in resolving disputes over the proper treatment of these costs.

III. PROPOSALS RELATING TO THE HEALTH BENEFITS OF RETIRED COAL MINERS

These proposals were addressed in our September 9, 1993 testimony before the Ways and Means Committee.

Mr. McNulty. Thank you, Mr. Samuels.

Your testimony regarding H.R. 2617, which would permit certain military personnel to roll over a portion of separation pay expressed some concern over the expansion of IRAs and the high cost of such expansion.

Would it be possible for your staff and the committee to work on some limited version of this proposal which would incorporate the concerns you have expressed today?

Mr. Samuels. Mr. McNulty, we would be glad to work with you and the staff in reviewing all possible options. Military personnel separation pay presents a number of unique issues that we believe warrant further study.

Mr. McNulty. Thank you.

One proposal under consideration is to clarify the tax treatment of environmental remediation costs. Does Treasury support the goals of this proposal?

Mr. Samuels. We are sympathetic with the goals of the proposal. We understand that the goals are to keep significant controversies outside of the courts and the administrative system.

Mr. McNulty. Some taxpayers have suggested that such legislation is not needed and that these issues could continue to be decided at the administrative level. What potential problems do you see with that approach and could we anticipate that your staff would assist in attempting to develop an equitable proposal in this area?

Mr. Samuels. There is a debate on the scope of current law and these issues depend on facts and circumstances in many cases. Accordingly, it is not clear that the issues will be solved at the administrative level. The issues are complex and the area I think needs a great deal of work to develop a fair and equitable proposal.

We would look forward to working with the committee and the staff in trying to develop an appropriate set of rules that reflect the goals of this proposal.

Mr. McNulty. As you know, the House passed a provision earlier this year to beef up IRS reporting for payments to service providers, including corporate service providers. However, the provision met considerable opposition in the Senate primarily from small businesses concerned about the potential paperwork burden.

In your view, how serious is the compliance problem that the proposal seeks to address and would it be possible to redraft it so that businesses would not have to generate large amounts of additional paperwork?

I think we would be particularly interested in your answer to this in light of the current initiative by the Vice President.

Mr. Samuels. At the time that the administration made the proposal on information reporting, the Treasury estimated that this compliance initiative would raise approximately $6 billion over 5 years. Accordingly, we believe that this initiative is quite important and that compliance issues, especially during the period of deficit reduction, should be considered very carefully.

We believe that during the discussion of this proposal there was a certain amount of misunderstanding and confusion over exactly what paperwork would be required. We have suggested exclusions that would reduce the paperwork burden and still allow the compliance initiative to have a material effect. We would be pleased to work with the subcommittee and the staff in explaining the various exclusions that we considered when objections were raised during OBRA 1993 considerations, and we believe that when you look at those exclusions, the paperwork burden on small businesses would be reduced significantly.

Mr. McNulty. Regarding the proposal to increase the rate of withholding on gambling winnings above 28 percent, would you be willing instead to broaden the base of gambling that is subject to withholding; for example, winners of high-stakes bingo and keno, and how would you suggest defining high stakes?

Mr. Samuels. The administration would be willing to consider broadening the base of gambling subject to withholding to cover, for example, high-stakes bingo and keno.

With respect to the definition of what constitutes "high stakes," we would like to discuss that with the staff and, in those discussions, arrive at a common understanding of the facts on the types of games that are now existing and, based on that examination, determine what the level should be for high stakes.

Mr. McNulty. Your written testimony indicates the Treasury has some concerns about a proposal to add sex discrimination to the existing list of discriminations that could cause a social club to lose its Federal tax exemption.

Could you spell out the nature of your concerns in this area?

Mr. Samuels. We have concerns that the proposal could affect longstanding and noncontroversial practices. For example, the proposal would apply to sororities and fraternities and we think that the proposal is not intended to cover those types of organizations. We think that once you decide that certain social clubs should not be affected by the proposal, it then becomes difficult to draw lines between which social clubs can continue their practices and which social clubs cannot.

Mr. McNulty. Mr. Hancock.

Mr. Hancock. Thank you, Mr. Chairman.

You know, back in 1986 and prior to that, we talked about simplifying the tax law. Now, the President is talking about coming up with one form for health care, which will be really interesting. It may be one form, but it will probably take three computers to calculate and use it.

The exercise we have been going through with revenue enhancers and revenue reductions, if in fact all of the things that we are talking about, should become law, roughly how many pages do you think we will be adding to the Internal Revenue Code?

Mr. Samuels. Mr. Hancock, I think it would be significant. The number of proposals on which we have testified going back to our June testimony and today is over 250. So that would be a very significant addition to the Internal Revenue Code, and that is why in the summary of my statement I mentioned that we are concerned about having too many changes in the tax law and giving both the government and taxpayers and their advisors time to adjust. So I share your concerns.

Mr. Hancock. I just came back from a weekend and I got a report from my accountant, just on what already has become law, how the changes in the income tax were going to affect me and my business. I got a stack of paper like this, and I spent Saturday evening reading it and looking at it. I am hearing from the business community that as long as we are doing this, they don't know what to do.

Now are we benefiting the economy by basically holding a threat in front of the people that want to operate a little bit, so they don't know what to do? What is your position? Should we put out the word that yes, we are going to give you guys a chance to get a little breather before we start making a lot of these changes?

Does the Department of the Treasury take the position that we ought to compound what we have already done by another 250 pages of regulations?

Mr. SAMUELS. Mr. Hancock, I think that in all of these matters, one has to balance various considerations. I would note that a significant number of the proposals that we are considering have been, I am sure, suggested by particular groups, including various business groups, so they have an interest in some of these proposals.

As reflected in our testimony, we think that there are several of the proposals that are meritorious and should get serious consideration by the committee. There also is a whole series of proposals that we would not support and some we would actually oppose.

We think that on balance if the subcommittee wants to have a markup and consider a bill, that they should consider doing it in a rather modest way in terms of the issue of adding complexity to the tax law and that that is a valid consideration for the committee to take into account in making its decisions on what should be included in the markup.

Mr. HANCOCK. Well, I appreciate that and I think you are exactly right. I think that my constituents, the small business people—I am a small businessman—are saying give us a moratorium. Let us digest what you have already done and make plans. But as you know, they don't know how to operate with all this pending legislation.

One gentleman tells me that he made a telephone call. He said, "I had planned on buying an additional inventory, $450,000 worth of machinery." He said, "I am not going to do it now." That is $450,000 worth of machinery that he was ready to buy that somebody is not going to manufacture.

The reason: He said, "I don't know what is going to happen under these depreciation schedules, et cetera." I suggest that maybe we could hold off a little bit on a lot of these changes. I recognize that certain things need to be changed, but I don't know but that we might not be better off to go back and look at existing income tax law and see if we can come up with one form, one sheet of paper where the average Ph.D. could fill out his own income tax return.

Thank you, Mr. Chairman.

Mr. MCNULTY. Mr. Kopetski?

Mr. KOPETSKI. Thank you, Mr. Chairman.

I have a question on your testimony, Mr. Samuels. Actually I want to go to the last page first, "No. 2: Disallow deductions for compensatory damages under certain environmental laws."

Your policy here is that—I assume the administration's policy is to encourage the cleanup and therefore you are going to allow the deduction for—you favor existing law of continuing the deduction for compensatory payments.

Mr. SAMUELS. That is correct.

Mr. KOPETSKI. Essentially what the policy is saying is that those who are not complying, unless there is a punitive damage situation, all they have to do is wait and if they get caught, then there is—they are not out any money; the Federal Treasury is.

Mr. SAMUELS. As we understand the proposal, Mr. Kopetski, fines and penalties will continue to be nondeductible. What is at issue in the proposal is whether compensatory damages would continue to be deductible.

In that case, for example, damages paid to people who have been adversely affected by the pollution would be able to be paid by the polluter to compensate them for their lost income and that type of payment to innocent parties would continue to be deductible if it was in the nature of compensatory damages.

It seems to us that at this point there is not a need to change the rule, which generally has permitted over the years payment of compensatory damages to innocent people to be deductible. If you deny the deduction, you may discourage the polluter from wanting to make appropriate settlements with the people who have been adversely affected.

There is a balance of trying to decide what is an appropriate tax rule for someone who has polluted and balance that with payments to people who have been adversely affected.

Mr. KOPETSKI. So these are payments that are going to a third party, not the actual cost of the cleanup that is involved?

Mr. SAMUELS. The cost of the cleanup is a separate issue. As I understand this proposal it covers payments primarily going to third parties, or reimbursements to a person who had to clean up the site by the person who had polluted the site.

Mr. KOPETSKI. So our policy in the Tax Code therefore is for the American taxpayer to pay for the injuries done to third parties, because that is really what is going on?

Mr. SAMUELS. It is correct that the Tax Code would allow for deductions for ordinary and necessary expenses. We generally don't disallow deductions as long as the payments are not fines or penalties, depending on the nature of the business or the activity that gave rise to the payments.

Mr. KOPETSKI. But in essence, it is the American taxpayer that is compensating injured third parties for environmental degradation caused by the principal?

Mr. SAMUELS. That is correct.

Mr. KOPETSKI. Well, I think that is something that I hope the administration would take another look at. But then if you go back to page 15—I always like to have consistency of policy as much as I can. That way I don't get in too much trouble with my constituents.

If I understand the hydrochlorofluorocarbons issue, HCFCs—the code currently tries to move people, businesses away from utilizing CFCs to HCFCs and it is my understanding that this is actually a temporary bridge because as they move to HCFCs the next step is to go to something else, and that won't have a potential environmental degradation as HCFCs do.

So it is my understanding that we are trying to encourage businesses to go to HCFCs and yet the proposal would tax HCFCs and it seems to me if on the one hand on the compensatory damage issues you were trying to encourage environmental cleanup that under this proposal, under No. 9, that you are actually going to have the effect of discouraging more environmentally benign action.

Do I make myself clear on that?

Mr. SAMUELS. Yes, sir.

Mr. KOPETSKI. Is that OK with you to have this inconsistency in environmental policy?

Mr. SAMUELS. We prepared this testimony in conjunction with EPA and they reviewed this and, as I understand it, one aspect of the decision with respect to this proposal is that it basically was following the 1992 Copenhagen Amendment to the Montreal Protocol. In the past when chemicals have been added pursuant to the Montreal Protocol, those chemicals have then been added to the group of chemicals that would be subject to this particular excise tax.

Mr. KOPETSKI. But isn't it the case that these chemicals have not been listed officially as of yet, so we may be taxing them before they are actually placed on this list?

Mr. SAMUELS. Mr. Kopetski, I am not aware of that. We will check and be happy to get back to you.

Mr. KOPETSKI. If you could ask EPA also to reflect upon the consistency or inconsistency of policy that I perceive between those two differing tax measures. In addition, while you are asking them, it is my understanding also that one of the chemicals at issue is methyl bromide which in the forest product industry is something that is used to treat logs coming in or going out of this country for insects, et cetera; yet there is a scientific question still as to whether that particular chemical, a scientific question of whether that is harmful and whether it should be listed.

Again, the issue is whether we should tax these substances before they are actually officially put on the list?

Mr. SAMUELS. We will consult with EPA and get back to you on that.

[The following was subsequently received:]

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

NOV 03 1993

The Honorable Michael J. Kopetski
House of Representatives
Washington, D.C. 20515

Dear Mr. Kopetski:

On September 21, 1993, I testified before the Subcommittee on Select Revenue Measures on several miscellaneous revenue issues, including a proposal to expand the ozone-depleting chemicals excise tax. At the hearing you raised questions regarding this proposal. Because your questions involved issues involving the Environmental Protection Agency (EPA), we have consulted with them to respond to your questions. I am also sending a copy of this letter to Chairman Rostenkowski so his record of the hearing will be complete.

Your first question related to hydrochlorofluorocarbons (HCFCs), which are less environmentally damaging than chlorofluorocarbons (CFCs). You asked whether it was appropriate to tax HCFCs when industry is being encouraged to use these chemicals as a substitute for CFCs.

HCFCs are viewed under the Clean Air Act and the Montreal Protocol as a transitional CFC substitute the use of which will allow a speedy phase-out of CFCs. HCFCs, however, also contribute to ozone depletion, although to a lesser degree than CFCs. Accordingly, the use of HCFCs is restricted and their production phased out.

Imposing the ozone-depleting chemicals tax on HCFCs is not expected to encourage firms to continue their use of CFCs. The tax on a compound is based on the compound's ozone-depletion potential, which is substantially lower for HCFCs than for CFCs. Thus, a tax on HCFCs would not eliminate the incentive to switch from more heavily taxed CFCs. Moreover, a tax on HCFCs would provide an incentive for industry to continue its efforts to find and shift to non-ozone-depleting substances.

You also expressed concern that HCFCs, hydrobromofluorocarbons (HBFCs), and methyl bromide have not been officially listed as ozone-depleting chemicals and that they might be taxed before they were actually listed. In addition, you suggested that there is still a scientific question as to whether methyl bromide, which is used as a pesticide in the forest products industry, is harmful.

At their meeting in 1992, the Parties to the Montreal Protocol added HCFCs, HBFCs, and methyl bromide to the list of controlled substances (i.e., substances subject to limitations on production and use because of their ozone-depletion potential). This amendment to the list of controlled substances will enter into force after ratification by 20 of the Parties. It is possible that this will occur before the end of the year, and it is likely that the United States will ratify the amendment within the next month.

In addition, the Clean Air Act specifies limits on HCFCs and calls for EPA to add to the list of regulated substances any compound with an ozone-depletion potential of 0.2 or more. The best available scientific information (from the Montreal Protocol Scientific Assessment) concludes that the ozone-depletion potential of both HBFCs and methyl bromide is well above the 0.2 threshold. Accordingly, EPA issued proposed regulations in March of this year that would add HBFCs and methyl bromide to the list of Class I compounds (i.e., substances that must be phased out within seven years of listing). EPA expects to finalize this proposed rule before the end of the year, and the listing will take effect 30 days after the rule is finalized.

I hope this is responsive to your concerns. Please let me or my staff know if we can provide any additional information on this issue.

Sincerely,

Leslie Samuels

Leslie B. Samuels
Assistant Secretary
(Tax Policy)

cc: The Honorable Dan Rostenkowski

Mr. KOPETSKI. I appreciate that very much. Thank you very much.

Thank you, Mr. Chairman.

Mr. MCNULTY. Thank you very much for your testimony, Mr. Secretary.

Mr. SAMUELS. Thank you.

Mr. MCNULTY. We now call the GAO, Mr. Natwar Gandhi, Associate Director for Tax Policy and Administration Issues.

Welcome, Mr. Gandhi. You may proceed to summarize your testimony if you wish. The testimony in its entirety will be made a part of the record.

STATEMENT OF NATWAR M. GANDHI, ASSOCIATE DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY TOM SHORT, ASSIGNMENT MANAGER, AND DAVID PASQUARELLO, EVALUATOR, PHILADELPHIA GENERAL ACCOUNTING OFFICE

Mr. GANDHI. Thank you, sir.

I am pleased to have this opportunity to offer our views on the need to improve taxpayer compliance with real estate deduction tax law. Joining me on my left is Mr. Pasquarello of our Philadelphia General Accounting Office and on my right is Assignment Manager Tom Short, who has worked on these and other tax issues.

As you may know, Mr. Chairman, we recently issued a report that recommended ways to improve the compliance of taxpayers who overstate their real estate tax deductions. At the end, I will also briefly comment on two other reports and proposals before the subcommittee, the debt forgiveness and automated verification of taxpayer identification numbers.

I will make three major points about overstated deductions for real estate tax payments. First, individual taxpayers mostly overstated their deductions for real estate taxes by including nondeductible payments such as user fees.

Two, confusion over which payments were and which were not deductible real estate taxes contributed to taxpayer noncompliance.

Last, IRS can improve compliance by simplifying tax documents and redirecting its enforcement efforts, working cooperatively with State and local officials.

IRS's compliance data showed that individual taxpayers overstated their real estate tax deductions by an estimated $1.5 billion for 1988. Projecting these figures to 1992, we estimated that this noncompliance led to a Federal tax loss of some $400 million. We believe these estimates understate the scope and tax effects of noncompliance. We found that in one large urban county, IRS auditors identified just 7 percent of the $21.6 million in overstated real estate taxes for 1 year.

As a result, we estimated that lost Federal tax revenue totaled $6 million and lost county and State tax revenue totaled $1.6 million. In this county, taxpayers overstated the $21.6 million by deducting user fees along with their real estate tax payments.

Our 1992 survey of 171 large local governments showed that the taxpayers in about half of these localities also were likely to include user fees in their real estate tax deductions.

In reviewing IRS files, Mr. Chairman, we could not determine whether taxpayers intentionally overstated the deductions. However, we were able to conclude that at a minimum, two types of confusion contributed to this noncompliance.

First, we found that many taxpayers were unaware that they should not deduct user fees. IRS's tax instructions did not clearly and completely tell taxpayers that user fees were nondeductible. We discovered that even private tax return preparers, who are more likely to know, misapply the deduction groups.

Second, local governments' real estate tax bills created confusion also. Although it is not required, these bills often did not distinguish between deductible real estate taxes and nondeductible user fees. As a result, taxpayers who relied on these bills to compute their real estate tax deductions could easily but improperly deduct their user fees, too.

We found a similar situation for taxpayers who relied on annual statements from mortgage companies to compute their real estate tax deductions. As with many of the local government bills, these mortgage statements did not distinguish between deductible and nondeductible payments to local governments.

We concluded, Mr. Chairman, that both IRS and local governments had key roles to play in improving taxpayer compliance. We envision these roles being played in tandem as IRS worked cooperatively with local officials.

Underlying such cooperation, we recommended that IRS clarify its rules and instructions on real estate tax deductions, that IRS help local governments to revise their bills so that taxpayers could readily identify the nondeductible user fees and know that IRS may also receive this information; that IRS require its auditors to contact local governments to identify the actual tax payments made by the taxpayers being audited; and finally, Mr. Chairman, we also recommended that IRS negotiate agreements with local governments to receive data on actual real estate tax payments by each individual taxpayer and use that data to identify noncompliance.

Since we issued a report in January of this year, we have continued to talk with IRS and local government officials about improving compliance with real estate tax deductions. We commend IRS for starting to work cooperatively with local government officials, particularly the National Association of Counties, so-called NACo, which has acknowledged this compliance problem and has proposed Federal legislation to implement the spirit if not the letter of our recommendations.

NACo's proposal also called for Federal funding to reimburse local governments for changes they would need to make to their accounting systems to track these types of payments and to their tax bills.

Although we have not fully analyzed this proposal, we view it as a reasonable first step. For the first time, the taxpayers across the country would begin to receive consistent information that distinguishes between deductible taxes and nondeductible fees or other payments. Besides improving tax compliance and revenues, these changes would add fairness and certainty to our tax system.

If these changes do not improve compliance, then IRS and Congress may wish to try another approach. One approach would be to require local governments to file an information return on the amount of realistic taxes that a taxpayer may deduct.

In requiring reporting, Congress would have to consider giving local governments the authority to collect taxpayers Social Security number so that the reported information can be used effectively. In recent years, we have strongly supported information reporting. It helps taxpayers to comply voluntarily and IRS to identify any remaining noncompliance. However, it also imposes costs and burdens on IRS as well as on the third party that reports the information.

In the context of real estate tax payments, local governments believe and we agree that the cost of information reporting may at least initially exceed its benefits. For this reason, we prefer trying first the proposal that we and NACo have recommended.

Before closing, Mr. Chairman, I would like to comment on two other proposals. These proposals involve debt forgiveness and automated verification of Federal tax identification numbers, so-called TINs. I will be brief, but I am willing to provide more information.

Regarding debt forgiveness, we issued a report in February 1993 on individual taxpayers who had not reported income from having their debts forgiven by FDIC and RTC. We found that individual's compliance in reporting this income from debts forgiven by FDIC skyrocketed from 1 percent to 48 percent when information returns were filed.

We also found that these federally forgiven debts were loans that had been made by private financial institutions that had been forgiving large amounts of debts themselves, some $40 billion in 1990 alone.

We recommended that Congress require FDIC and RTC to file such information returns when the annual forgiven debts totaled $600 or more. If this information reporting proves to be cost effective, we also suggested that Congress consider extending this reporting to other institutions.

Recently Congress acted on our recommendations. The Joint Committee on Taxation estimated that this provision would raise $484 million in fiscal years 1994 through 1998.

We understand that the proposal being considered today would extend such information reporting to all financial institutions that make or acquire loans. We believe the proposal before you today, sir, would improve tax compliance. Also, including all private financial institutions would better insure that no segments of this community have a competitive advantage by being able to avoid the cost of reporting.

We also have done some reports that discuss the benefits of automatically verifying the Federal tax identification number of taxpayers before sending in an information return on payments made to them. We understand this proposal has been withdrawn for now. Even so, we wish to state our support for such a verification system.

Although IRS still needs to work out technical bugs in the verification system, we believe this system will benefit not only IRS, but also those who need the valid TIN to file an accurate information return. To the extent that this system allows things to be verified in advance rather than years later, the cost and burden on all affected parties should be reduced.

This verification also should limit opportunities for submitting false TINs, which some taxpayers may try to escape Federal taxes. Closing off these opportunities is crucial to help insure that the correct amount of taxes is paid and the millions of honest taxpayers are treated fairly.

Mr. Chairman, this concludes my oral statement. I request that my written testimony be made part of the record.

Thank you for the opportunity to present our views. I welcome any questions that you may have.

Mr. McNULTY. Thank you. Your statement will appear in the record in its entirety.

[The prepared statement follows:]

TESTIMONY OF NATWAR M. GANDHI
ASSOCIATE DIRECTOR
TAX POLICY AND ADMINISTRATION ISSUES
GENERAL GOVERNMENT DIVISION
U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to offer our views on the need to improve taxpayer compliance with real estate tax deduction law. As you may know, we recently issued a report, requested by Chairman David Pryor, Senate Finance Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service (IRS), that recommended ways to improve the compliance of taxpayers who overstate their tax deductions for real estate tax payments.[1] To conclude my statement, I will briefly comment on two other proposals before the Subcommittee--debt forgiveness and automated verification of taxpayer identification numbers (TIN).

I will make three major points about overstated deductions for real estate tax payments, on the basis of the work we did for our report. These points are:

-- Individual taxpayers mostly overstated their deductions for real estate tax payments by including nondeductible payments such as user fees.

-- Confusion over which payments were and were not deductible real estate taxes contributed to taxpayer noncompliance.

-- IRS can improve taxpayer compliance by simplifying tax documents and redirecting its enforcement efforts, working cooperatively with state and local officials.

BACKGROUND

Before discussing these three points, let me describe the deduction for real estate tax payments. Under tax law, taxpayers may deduct real estate tax payments from their federal taxable income. Real estate taxes are uniform payments that are based on the value of a taxpayer's real estate; they are used to fund general services. Other payments to local governments, such as user fees, generally cannot be deducted because they do not meet these criteria. User fees fund the use of specific services such as water, sewerage, and trash collection and are not based on the value of real estate.

OVERSTATED REAL ESTATE TAX DEDUCTIONS REDUCED INCOME TAX REVENUES

IRS compliance data showed that individual taxpayers overstated their real estate tax deductions by an estimated $1.5 billion for 1988. Projecting these results to 1992, we estimated that this noncompliance led to a federal tax loss of $400 million.

We believe these estimates understate the scope and tax effect of the noncompliance. We analyzed the IRS audits that generated the compliance data.[2] We found that in one large urban county, IRS auditors identified just 7 percent of the $21.6 million in overstated real estate taxes for 1 year. As a result, we estimated that the lost federal tax revenue totaled $6 million and lost county and state tax revenue totaled $1.6 million.[3]

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[1] Tax Administration: Overstated Real Estate Tax Deductions Need to Be Reduced (GAO/GGD-93-43, Jan. 19, 1993).

[2] IRS did these audits to measure compliance through its Taxpayer Compliance Measurement Program (TCMP). TCMP audits constitute a detailed, rigorous examination of taxpayer compliance in reporting all types of income, deductions, credits, etc..

[3] Reducing overstated real estate tax deductions boosts federal tax revenue as well as state and local tax revenue in those states that levy income taxes and use the federal tax liability as a starting point for computing the state income tax liability.

In this county, taxpayers overstated the $21.6 million by deducting user fees along with their real estate tax payments. Our 1992 survey of 171 large local governments showed that taxpayers in about half of these localities also were likely to include user fees in their real estate tax deductions. Although we did not have resources to estimate the noncompliance within these localities, we concluded that our $400 million estimate of the 1992 nationwide tax loss is probably understated.

TAXPAYER CONFUSION CONTRIBUTED TO THE OVERSTATED DEDUCTIONS

In reviewing IRS' files, we could not determine whether taxpayers intentionally overstated the deductions. However, we were able to conclude that, at a minimum, two types of confusion contributed to taxpayers' noncompliance.

First, we found that many taxpayers were unaware that they should not deduct user fees. IRS' instructions for 1988 tax returns did not tell taxpayers that user fees were nondeductible. For these taxpayers to find this information, they had to consult multiple IRS publications. In order to comply voluntarily, these taxpayers had to persist in finding and interpreting the publications. We discovered, however, that even private tax return preparers, who are more likely to know, misapplied the deduction rules.

Second, local governments' real estate tax bills created confusion. Although it is not required, these bills often did not distinguish between deductible real estate taxes and nondeductible user fees. We identified 83 of the 171 large, local governments that each collected at least $100 million annually in real estate taxes and used the same bill for both user fees and real estate taxes. We asked them for copies of their bills. Of the 55 sample bills that we received, we found unclear distinctions between user fees and real estate taxes on 49 bills. Of these 49 bills, 31 made little or no distinction between them.

As a result, taxpayers who relied on these bills to compute their real estate tax deductions could easily, but improperly, deduct their user fees too. We found a similar situation for taxpayers who relied on annual statements from mortgage companies to compute their real estate tax deductions. As with many of the local government bills, these mortgage statements did not distinguish between deductible and nondeductible payments to local governments.

IRS CAN WORK WITH LOCAL GOVERNMENTS TO IMPROVE TAXPAYER COMPLIANCE

We concluded that both IRS and local governments had key roles to play in improving taxpayers' compliance. We envisioned these roles being played in tandem as IRS worked cooperatively with local officials. Underlying such cooperation, we recommended ways to improve compliance with the real estate tax deductions. We recommended that IRS

-- clarify its rules and instructions on the real estate tax deduction,

-- help local governments to revise their bills so that taxpayers could readily identify the nondeductible user fees and know that IRS may also receive this information,

-- require IRS auditors to contact local governments to identify the actual real estate tax payments made by the taxpayers being audited, and

-- negotiate agreements with local governments to receive data on actual real estate tax payments by each individual taxpayer and use that data to identify taxpayer noncompliance.

Since we issued our report in January 1993, we have continued to talk with IRS and local government officials about improving compliance with real estate tax deductions. We commend IRS for starting to work cooperatively with local government officials, particularly with the National Association of Counties (NACo), which represents almost all the local governments we contacted. Similarly, we are pleased that NACo has acknowledged this compliance problem and has offered a proposal to improve the compliance.

NACo recently approved a resolution that proposed federal legislation to implement the spirit, if not the letter, of our recommendations. As we understand the proposal, IRS would clarify its instructions and tax returns and local governments would clarify their bills. IRS also would work with mortgage companies to help them in clarifying their annual statements to taxpayers. Such clarifications should provide the information that taxpayers need to voluntarily comply. NACo's proposal also called for federal funding to reimburse local governments for changes they would need to make to their accounting system to track these types of payments and to their tax bills.

Specifically, under NACo's proposal, IRS would help local taxing districts to determine the deductibility of various payments. Then local tax bills would be revised to distinguish between deductible and nondeductible payments. In addition, IRS would clarify the tax return line on which individual taxpayers can claim the real estate tax deduction. Requiring taxpayers to compute the deductible amount by subtracting the nondeductible payments should prompt them to be more compliant.

In our view, NACo's approach approximates the approach that IRS envisions under its current compliance philosophy. That is, if the noncompliance appears to stem from taxpayer confusion, then nonenforcement efforts should be tried first. NACo's approach requires IRS to provide taxpayers with the information needed to comply and to change its tax instructions and returns to clear up any confusion.

Although we have not fully analyzed this proposal, we view it as a reasonable first step. For the first time, taxpayers across the country would begin to receive consistent information that distinguishes between deductible taxes and nondeductible fees or other payments. Besides improving tax compliance and revenues, these changes would add fairness and certainty to our tax system.

We have not received estimates on the amount of money from federal or other sources that local governments would need to change their systems. If the changes are likely to lead to major increases in tax revenues, we believe that a one-time "seed" investment to reimburse local governments, either fully or partially, for their costs makes sense. Because many state governments, as well as some local governments, also will receive increased tax revenues, perhaps they should share a portion of these costs.

If these changes do not improve taxpayer compliance, then IRS and Congress may wish to try another approach. One approach would be to require local governments to file an information return on the amount of real estate tax that a taxpayer may deduct. In requiring reporting, Congress also would have to consider giving local governments the authority to collect taxpayers' social security numbers (SSN) so that the reported information can be used effectively.

In recent years, we have strongly supported information reporting. It helps taxpayers to comply voluntarily and IRS to identify any remaining noncompliance. However, it also imposes costs and burdens on IRS as well as on the third party that reports the information. In the context of real estate tax payments, local governments believe and we agree that the costs of information reporting may, at least initially, exceed its benefits. For this reason, we prefer trying first the proposals that we and NACo have recommended.

Another approach would be for Congress to eliminate the confusion by either eliminating a deduction for real estate taxes or allowing a deduction for user fees. We have not examined the trade-offs of either denying or expanding the deduction. Because either action would have a significant impact on revenue, we believe that careful consideration would be necessary before choosing this approach.

DEBT FORGIVENESS AND AUTOMATED TIN VERIFICATION

Before closing, I would like to comment on two other proposals. These proposals involve debt forgiveness and automated verification of federal TINs. I will be brief, but I am willing to provide more information.

Regarding debt forgiveness, we issued a report in February 1993 on individual taxpayers who had not reported income from having their debts forgiven by the Federal Deposit Insurance Corporation (FDIC) or Resolution Trust Corporation (RTC).[4] We found that individuals' compliance in reporting this income from debts forgiven by FDIC skyrocketed from 1 percent to 48 percent when information returns were filed. We also found that these federally forgiven debts were loans that had been made by private financial institutions that had been forgiving large amounts of debts themselves ($40 billion in 1990).

We recommended that Congress require FDIC and RTC to file such information returns when the annual forgiven debts totaled $600 or more. If this information reporting proves to be cost effective, we also suggested that Congress consider extending this reporting to other institutions.

Recently, Congress acted on our recommendations. Congress required FDIC, RTC, and certain other financial institutions and federal agencies to file information returns on forgiven debts of $600 or more in a calendar year. The Joint Committee on Taxation estimated that this provision would raise $484 million in fiscal years 1994 through 1998.

We understand that the proposal being considered today would extend such information reporting to all financial institutions that make or acquire loans. The loans forgiven by FDIC and RTC had been made by private financial institutions. We see no reason to believe that individuals' compliance in reporting the income from loans forgiven by these institutions would be any better, without information reporting, than the 1-percent compliance we found in our sample of taxpayers with federal loans forgiven. Thus, the proposal before you today should improve tax compliance. Further, including all private financial institutions would better ensure that no segments of this community have a competitive advantage by being able to avoid the cost of reporting.

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[4] Tax Administration: Information Returns Can Improve the Reporting of Forgiven Debts (GAO/GGD-93-42, Feb. 17, 1993).

We also have done some reports that discussed the benefits of automatically verifying the federal TIN of taxpayers before sending in an information return on payments made to them.[5] We understand this legislative proposal has been withdrawn for now. Even so, we wish to state our support for such a verification system.

Although IRS still needs to work out technical bugs in the verification system that it is developing, we believe this system will benefit not only IRS but also those who need the valid TIN to file an accurate information return. To the extent that this system allows TINs to be verified in advance rather than years later, the costs and burdens on all affected parties should be reduced. This verification also should limit opportunities for submitting false TINS, which some taxpayers may try to escape federal taxes. Closing off these opportunities is crucial to help ensure that the correct amount of taxes is paid and the millions of honest taxpayers are treated fairly.

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Mr. Chairman, this concludes my statement. Thank you for the opportunity to present our views. I welcome any questions that you may have.

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[5] Tax Administration: Approaches for Improving Independent Contractor Compliance (GAO/GGD-92-108, July 23, 1992) and Tax Administration: Federal Agencies Should Report Service Payments Made to Corporations (GAO/GGD-92-130, Sept. 22, 1992).

Mr. McNulty. I just have a couple of questions. On the overall question of paperwork reduction, everyone is very interested in this subject. Do you think that the information reporting can be extended to the corporate service providers without imposing an intolerable paperwork burden on the private sector and the IRS?

Mr. Gandhi. I would like to address this issue of the information reporting in this fashion. I think above all we must recognize the basic compliance problem. If you were to look at the numbers of the tax gap, which is a result of the tax that is owed but not paid, then you would see that the tax gap for small corporations was $7 billion in 1992. Half of it results from unreported income; $3½ billion, and that is growing.

In other words, unreported income by small corporations in 1980 was about $5 billion. By 1987, that had risen threefold, to $15 billion. The question is how do you go about closing that gap?

Second, I think there are ways in which you can modify the information reporting to reduce the burden. For example, you can think in terms of not issuing the information returns to large corporations. That is, if a large corporation were to provide these kind of services to a small corporation, then information reporting on that could be exempted.

You can also exempt information reporting for federally regulated corporations. But above all, we want to keep in mind that information returns induces compliance.

It does it two ways. It reminds the recipient that he or she has received the income.

Second, it would tell him or her that IRS also has the information.

The study I mentioned in my testimony about debt forgiveness provides an example. These are the debts forgiven by FDIC and RTC. When these debts were forgiven say in 1989, the compliance was 1 percent. When they had information reporting on such debts, that compliance skyrocketed to 48 percent. And it also gave information to IRS to locate those who did not file returns.

If you add in IRS's part, then total compliance eventually was something like 68 percent. So you can see that information reporting improves compliance very much. At the same time, it really saves IRS from going in strong with harsher enforcement measures such as auditing, examination, and other matters. So I would strongly urge that the whole issue of information reporting should be viewed in this perspective.

Mr. McNulty. Thank you.

In your study on reporting of debt forgiveness income, did you find any evidence that it would be more difficult for nonbank financial institutions to comply with the reporting requirement?

Mr. Gandhi. I don't think so, sir.

Mr. McNulty. Do you have any figures on the percentages of loans currently being originated by nonbanks?

Mr. Gandhi. We don't. We haven't studied that subject.

Mr. McNulty. It might be interesting to look at that. If we could have that information, we would appreciate it.

Thank you very much for your testimony.

[The information follows:]

One way to answer this question is to start with the portion of loans held by banks and thrift institutions. According to data published by the Federal Reserve Board on all types of loans, banks ($3 trillion) and thrifts ($1.1 trillion) held about $4.1 trillion of the current loans through the second quarter of 1993. This $4.1 trillion represents:

1) Thirty-five percent of the $11.8 trillion in loans among all financial institutions. As a result, nonbank financial institutions accounted for 65 percent ($7.7 trillion).

Such institutions included insurance, mortgage, pension, mutual or money market fund, finance, and trust companies, among others.

2) Twenty-seven percent of the $15.3 trillion in loans among all institutions. As a result, all nonbank institutions, including financial ($7.7 trillion) and nonfinancial ($3.5 trillion) accounted for 73 percent ($11.2 trillion).

Nonfinancial institutions included nonfinancial businesses ($0.3 trillion); federal, State and local governments ($0.8 trillion); foreign institutions ($1.1 trillion); and households ($1.3 trillion).

Mr. McNulty. We will now proceed to panel No. 1.

Representing the National Association of Manufacturers, William G. Dakin, senior tax counsel, Mobil.

Representing the National Association of Home Builders, Mark Kalish, executive vice president, Michael T. Rose Associates, Laurel, Md.

Representing the U.S. Chamber of Commerce, Julie Gackenbach, director of tax policy.

Representing the American Institute of Certified Public Accountants, Pamela J. Pecarich, chairman, Tax Legislative Liaison.

STATEMENT OF WILLIAM G. DAKIN, VICE CHAIRMAN, TAXATION POLICY COMMITTEE, NATIONAL ASSOCIATION OF MANUFACTURERS, AND SENIOR TAX COUNSEL, MOBIL CORP.

Mr. Dakin. I am William Dakin. On behalf of the NAM, I appreciate this opportunity to present NAM's views on some of the proposals you are considering today.

With respect to the foreign tax provisions, we agree that how the United States taxes the income the U.S. companies earn from their international operations should be examined both for its impact on the competitiveness of U.S. companies and for long overdue simplification. But we think that that examination should look at our system of taxation as a whole and not piecemeal.

Each of the individual proposals before you today would increase taxes on some or another segment of our foreign trade and commerce, but none attempt to solve the problems that exist in how we tax the income that our companies earn operating internationally.

As you evaluate these proposals, we think a good question to ask is whether adopting them would help or harm U.S. jobs. According to the Department of Commerce, each billion dollars in U.S. exports maintains directly and in directly about 19,000 jobs in the United States. Exports currently sustain about 9 million U.S. jobs, of which about half are new jobs that were created by export growth since 1985. So the proposal to increase taxes on exports by changing the sourcing of income from the sale of inventory property would damage a sector of the economy that has been a major source of job creation.

The proposal would go further and increase taxes on the worldwide trading activities of U.S. companies and handicap them vis-a-vis their foreign competitors. The element of the proposal that would require an examination of sales to foreign affiliates and include their factors in the composition of the mix would add a great deal of complexity to what is already a complex law.

The proposal to convert the foreign tax credit into a deduction is more fundamental. It would raise the effective tax rate on income earned outside the United States from the 35 percent statutory rate to over 55 percent if the foreign country taxed the same way we do here in the United States.

Changing the credit to a deduction would make it difficult if not impossible for U.S. companies to compete with foreign companies for business opportunities outside the United States. We cannot compete effectively at home unless we are free to compete abroad. We can't surrender foreign markets to other companies and retreat to our own shores and expect to prosper.

With respect to the compliance provisions or proposals, the proposal to deny corporations a deduction for interest paid to the IRS on tax deficiencies is at odds with the fundamental principle of our tax law that we impose tax on the income remaining after payment of all ordinary and necessary expenses. One of these expenses is determining one's liability for tax.

Business today is often complex and certainly the Tax Code is. As the director of taxes at General Mills put it, "There are areas of the Tax Code where you have no way of telling whether you are coming up with the right answer because of the complexity. You wait until the audit and hope you can come to an understanding with the government."

Based on my own experience, I would say that is an understatement. It is not uncommon to take many years to—for the IRS to take different views from taxpayers leaving it to the courts to decide who is right many years after the disputed transaction occurred. If the taxpayer prevails and the IRS pays interest to the taxpayer, then the taxpayer is taxable on that interest. We think that symmetry and fairness require that if the IRS prevails and the taxpayer pays interest, that the interest should continue to be deductible by that taxpayer as it has been since we have had a corporate income tax.

On another proposal, we point out that corporations already pay a very high rate of interest on tax deficiencies, 5 points above the Federal short-term rate, and it would be unnecessary and wrong to add to this burden by increasing the rates further in some unspecified amount as another proposal would do.

We think that the accuracy related penalties in the code are quite adequate to deter taxpayers from taking unsubstantiated positions on their tax returns and that no further action is warranted.

Under the category miscellaneous issues, it is not entirely clear what the proposal with respect to environmental laws is. It has been variously described as a proposal to deny deductibility on compensating a victim of an environmental spill or to deny a deduction for cleaning up a spill. But whichever the proposal is, the tax analysis is exactly the same. It is an example of attempting to convert our system from a tax on net income into something else.

If you spill something, you naturally want to clean it up and you naturally want to compensate anyone who might have been damaged. Those are real costs that you incur and they should be taken into account in determining your income.

The environmental laws already provide very substantial penalties where Congress considered them to be appropriate and those are not deductible for tax purposes. To disallow deductions, either for compensating a victim of a spill or for cleaning up a spill, would in effect be using the Tax Code to penalize indirectly what Congress has not seen fit to penalize directly. We don't think any more penalties are needed.

If the issue is raised, it ought to be addressed directly and not through the back door of the Tax Code.

With respect to the expensing or capitalization of environmental remediation costs, we do not think the legislation is timely at this time. Both IRS and Treasury are considering these issues and the matter may well be resolved administratively without the need for any legislation. The issue is an important one. The environmental spending will amount to many, many billions of dollars over the next few years, and to move from the existing rules about expensing to capitalization and to increase the after-tax cost of complying with the environmental laws and cleaning up the environment would be a very substantial burden and would we think be counterproductive to achieving our national environmental objectives.

That concludes my formal presentation unless there are questions.

[The prepared statement follows:]

TESTIMONY ON
MISCELLANEOUS REVENUE-RAISING PROPOSALS

BY

WILLIAM G. DAKIN
VICE CHAIRMAN OF THE TAXATION POLICY COMMITTEE
NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
U.S. HOUSE WAYS AND MEANS COMMITTEE

SEPTEMBER 21, 1993

I am William G. Dakin, Senior Tax Counsel of Mobil Corporation and Vice Chairman of the Taxation Policy Committee of the National Association of Manufacturers. The NAM has some 12,000 members, of which 8,000 are small manufacturers. I appreciate this opportunity to present the NAM's views on some of the proposals that you will be considering today.

FOREIGN TAX PROVISIONS

How the United States taxes income earned abroad should be examined both for its impact on the competitiveness of U.S. companies and for long overdue simplification, but that examination should look at the system as a whole and not piecemeal. Each of the five proposals before you today would increase taxes on our foreign trade and commerce, but none of them attempt to solve the serious problems that exist in how we tax the income that our companies earn outside the United States.

In evaluating these proposals a good question to ask is whether adopting them would help or harm U.S. trade and U.S. jobs. For example, U.S. manufactured exports account for between 30 and 40% of the nation's economic growth since 1987. According to the U.S. Commerce Department, each $1 billion in U.S. exports maintains, directly and indirectly, 19,000 jobs in the U.S. Exports sustain 9 million jobs--about half of these are new jobs created by export growth since 1985. The proposed change in how we tax U.S. exports (the sourcing of income from the sale of inventory property provision) would damage the one sector of the economy that has been a major source of job creation, as well as being administratively very complex.

More importantly, the proposal to convert the foreign tax credit into a deduction would raise the effective tax rate on income earned outside the United States from 35% to 55%, assuming that the foreign country imposes tax at the same rate as the United States. The purpose of the foreign tax credit is to prevent double taxation of foreign source income. Changing the credit to a deduction would make it difficult if not impossible for U.S. companies to compete with foreign companies for business opportunities outside the United States. U.S. companies cannot compete effectively at home unless we are free to compete abroad. We cannot surrender foreign markets to others, retreat to our own shores, and expect to prosper.

COMPLIANCE

The proposal to deny corporations a deduction for interest paid to the Internal Revenue Service on tax deficiencies is at odds with the fundamental principle of U.S. tax law that tax is imposed on the net income remaining after payment of all ordinary and necessary expenses. One of these expenses is determining one's liability for tax.

Business today is often very complex, and so is the tax code. As quoted in a recent article, Sandy Navin of General Mills stated:

> There are areas of the tax code where you have no way of telling whether you're coming up with the right answer, because of the complexity. You wait until the audit and hope you can come to an understanding with the government.[1]

It is not uncommon for the IRS to take a different view from a taxpayer, leaving it to the courts to decide who is right many years after the disputed transaction occurred. If the taxpayer prevails and the IRS pays interest on an overpayment of tax, the taxpayer must pay tax on that interest. Symmetry and fairness require that if the IRS prevails and the taxpayer pays interest on a deficiency, the interest should continue to be deductible by the taxpayer, as it has been since we have had an income tax.

Corporations already pay a very high rate of interest on tax deficiencies (5 points above the federal short-term rate) and it would be unjust to add to this burden by making the interest non-deductible.

The accuracy related penalty provisions of the Code are quite adequate to deter taxpayers from taking unsubstantiated positions on their tax returns. No further action is warranted.

MISCELLANEOUS ISSUES

The proposal to disallow deductions for compensatory damages under certain environmental laws is another example of attempting to convert our system from a tax on net income into something else. If a truck containing milk were so unfortunate as to have an accident, there is no question that the cost of cleaning up the spilled milk and compensating anyone damaged by the spill would be an ordinary and necessary expense of engaging in the milk business. The tax treatment of cleaning up a spill should not depend upon what was spilled, for example if the truck had contained oil or hazardous waste instead of milk.

The environmental laws provide substantial penalties where these are appropriate. These penalties are not deductible for tax purposes. To disallow a deduction for the expense of compensating persons damaged by an accident occurring in the course of business would in effect penalize indirectly conduct that Congress has not seen fit to penalize directly. The NAM does not think that additional penalties are needed, but if the issue is raised it should be addressed as such and not through the back door of the tax law.

The proposal to clarify the treatment of environmental remediation costs is at worst unnecessary and at best premature. These issues are under active consideration at IRS and Treasury and may well be resolved administratively, without the need for legislation. Revenue considerations are only one part of the formulation of a national environmental policy. Environmental spending will amount to many billions of dollars over the next few years. The impact on the business community will be substantial. Raising the after-tax cost of improving the environment would be counterproductive.

CONCLUSION

This concludes my formal presentation. I would be happy to take any questions.

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[1] Norton, Rob, "Our Screwed-up Tax Code," Fortune, September 6, 1993, p. 34

Mr. McNulty. We will go through the whole panel first and receive your statements, and then go to questions.

Mr. Kalish.

STATEMENT OF THOMAS N. "TOMMY" THOMPSON, FIRST VICE PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS, AS PRESENTED BY MARK KALISH, EXECUTIVE VICE PRESIDENT, MICHAEL T. ROSE ASSOCIATES, LAUREL, MD.

Mr. Kalish. Good morning, Mr. Chairman, members of the subcommittee.

I am Mark Kalish, executive vice president of Michael T. Rose Associates, a homebuilding and land development company in Laurel Md. I am also a member of the National Association of Home Builders, an association of 165,000 member firms engaged in all aspects of homebuilding and land development.

I am pleased to have this opportunity to appear before the House Ways and Means Subcommittee on Select Revenue Measures and to comment on certain of the miscellaneous revenue raising proposals which are the subject of these hearings. Specifically, my oral testimony will be on comments limited to the proposals on section 530 of the Revenue Act of 1978 and the capitalization and amortization of certain environmental remediation costs.

We, the National Association of Home Builders, oppose the repeal of the safe harbor contained in section 530 of the Revenue Act of 1978 for the construction industry. Our industry, building single family houses, is comprised mostly of small businessmen and businesswomen. Over 50 percent of our members build less than 10 houses per year. That is less than one house per month. Less than 2 percent of our builders build over 500 houses per year.

The single family homebuilding business is comprised of small businesses in virtually every community in the country. Because the construction of a home entails the transportation to a job site of a wide variety of different materials which are assembled or fabricated by a host of different trades at the job site and the home sites at which the trades work are located differently every day, the relationship between the homebuilder and the person who performs the different trades varies widely in our industry.

Another complicating factor, principally from the IRS approach to many homebuilders, is the fact that the homebuilder routinely subs out; that is, he hires independent subcontractors to perform services which may in the mind of the IRS constitute performance of common labor. In those instances, the IRS often alleges that the person is an employee rather than an independent contractor.

The construction of single family homes is basically the coordination of up to 18 different subcontractors. During the past 30 years, the role of the subcontractor and professional specialist in the homebuilding industry has increased significantly.

Framing, roofing, bricklaying, foundations, masonry are generally done by subcontractors on a labor only basis, with the material provided by the builder. Other jobs, such as flooring, insulation, and painting involves subcontractors which supply both labor and materials. The homebuilding industry as well as the nonresidential construction industry is characterized by extensive subcontracting of actual work.

The NAHB surveyed builders in 1987 and concluded that the majority of the contractors—that is those people who build for a fee on somebody else's land—and the merchant builders, those people who build on their own land and sell a house and the land to the buyer—the merchant builder usually acts as his own general contractor—have subcontracted more than 75 percent of the total construction costs. Larger builders subcontract an even larger share than small builders.

The same 1987 study indicated that residential builders subcontracted approximately $41 million or 40 percent of their construction receipts.

The primary reason for the extensive use of subcontractors is the fact that a typical specialist is only needed for a short period of time. It takes about 3 days to 4 days to put in a foundation. If you are only building 10 houses a year, that means that you are only using the subcontractor for maybe 30 or 40 days a year, and the subcontractor would then work for other people.

The general contractor doesn't have the expertise or the capacity to manage all the activities that each one of these specialists would have to take care of such as monitoring the hours worked, purchasing of material, et cetera. Therefore, the general contractor issues a subcontract based upon negotiation or competitive bids and leaves the subcontractor to figure out how to accomplish his work. The subcontractor is usually responsible for supplying the necessary building materials. Although the subcontractor's work may be subject to competitive bids, most builders develop long term relationships with their subcontractors just as consumers tend to patronize the same doctors and dentists and law firms.

Even in long-term relationships, the relationship between the general contractor and the merchant builder and the subcontractor is different than between the employer and the employee.

The general contractor merchant builder is not obligated to provide continuing employment for the subcontractor, but the subcontractor still remains liable for what he has done and all the building practices that he has employed.

We believe that the current rules under section 530 of the Revenue Act provide adequate relief for the construction industry, for the taxpayers who are involved in disputes with regard to worker reclassification.

Repeal of that section with respect to construction workers would be most harmful to businesses in regions which customarily sub out to independent contractors under factual circumstances and longstanding industry practices which may not satisfy the 20 factor tests.

Finally, I read in the Wall Street Journal that the health care proposals would define an employee to include independent contractors who earn more than 80 percent of their annual income from one employer. The President looked at the proposal and believed as we do that it would create a serious problem and dropped it in the package. We mention it here because of our serious concern and hope that the committee will follow the President's lead.

The second item that I would like to testify on is the capitalization and amortization of environmental remediation costs. The National Association of Home Builders opposes this proposal that would require environmental remedy costs to be capitalized and amortized over a uniform period. Any proposal to clarify the treatment of the environmental remediation costs by specifying costs which must be capitalized should not include unforeseen hazardous waste cleanup costs.

I would like to thank you on behalf of the National Association of Home Builders for the opportunity to present our views on these proposals and would be pleased to answer any questions.

Thank you.

Mr. McNulty. Thank you very much.

[The prepared statement of Mr. Thompson follows:]

STATEMENT

of

THE NATIONAL ASSOCIATION OF HOME BUILDERS

before the

SUBCOMMITTEE ON SELECT REVENUE MEASURES

COMMITTEE ON WAYS AND MEANS

of the

UNITED STATES HOUSE OF REPRESENTATIVES

on

MISCELLANEOUS REVENUE-RAISING PROPOSALS

September 21, 1993

Mr. Chairman and Members of the Subcommittee:

My name is Thomas N. "Tommy" Thompson, I am a builder from Owensboro, Kentucky. I am a second generation builder and current president of Thompson Homes. My company builds approximately fifty single-family homes each year. The company is also involved in multi-family housing, seniors housing, land development, property management, and general contracting.

I am currently serving as First Vice President of the National Association of Home Builders (NAHB), an association of 165,000 member firms engaged in all aspects of home building and land development. I am pleased to have the opportunity to appear before the House Ways and Means Subcommittee on Select Revenue Measures, and to comment on certain of the miscellaneous revenue-raising proposals which are the subject of these hearings. Specifically, I will comment on the proposals to repeal Section 530 of the Revenue Act of 1978, modify the standard for nonrecognition of gain on exchanges of like-kind property, and capitalization and amortization of certain environmental remediation costs.

1. REPEAL OF THE SAFE HARBOR UNDER SECTION 530 OF THE REVENUE ACT OF 1978 FOR CONSTRUCTION INDUSTRY EMPLOYERS

Congress enacted §530 of the Revenue Act of 1978 to provide relief to taxpayers involved in tax controversies. This Act provides generally that if a business: (1) did not treat an individual as an employee for any period; (2) filed all tax returns (including Forms 1099) on a basis consistent with its tax position; and (3) has a "reasonable basis" for treating the worker as an independent contractor, the government is not to raise the employment tax issue in an examination.

A reasonable basis that is acceptable under §530 includes having a case or ruling that supports the taxpayer's position, a previous IRS audit in which the independent contractor treatment resulted in no assessment, or a long-standing industry practice.

When a "safe haven" under §530 is found, a company is not subject to back taxes or penalties, or obligated in the future to withhold income taxes from contractor payments or pay employment taxes on independent contractors.

NAHB strongly opposes the proposal to modify the existing safe harbor in section 530 of the Revenue Act of 1978 to repeal the longstanding practice of an industry safe harbor with respect to the construction industry. This safe harbor is of direct and significant import to the building industry. Repeal with respect to construction workers would be most harmful to businesses and regions which customarily "sub-out" to independent contractors under factual circumstances which may not satisfy the twenty factor test.

INDUSTRY PROFILE

The industry, building single family housing, is comprised mostly of small businessmen and women. Over 50 percent of NAHB members build less than 10 houses per year. Approximately 15 percent build more than 25 houses per year and less than 2 percent of the builders build over 500 houses per year. The single family home building business is clearly comprised of small businesses in virtually every community in the country.

Because the construction of a home entails the transportation to a job site of a wide variety of different materials which are assembled and/or fabricated by a host of different trades and because such job site necessarily changes as the homes are built, the relationship between the homebuilder and the person who performs the different trades varies widely in this industry. Another complicating factor, principally from the standpoint of the approach the Internal Revenue Service has made to many homebuilders, is the fact that a homebuilder routinely does "sub-out"- that is, hire an independent contractor to perform services which may, in the minds of the IRS, constitute performance of "common labor". In those instances, the IRS often alleges that the person is an employee rather than an independent contractor. The construction of single family homes is basically the coordination of the work of up to 18 different subcontractors.

Since the volume of work in the homebuilding industry is very unpredictable and seasonal, there is a strong necessity for the business owners to match labor to business needs and not to be encumbered by large permanent payrolls. Ten years ago when there was a booming housing market, homebuilders found it efficient to maintain more full-time employees in all the skilled trades. In today's soft market, two out of three builder firms are organized as corporations and about one-fourth are sole proprietorships. During the last ten years, more builders have been organizing as Subchapter S corporations, so that they can combine limited liability with taxation on only individual earnings.

Builders' business organizational structure tends to depend on the size of the business. About 25 percent of small-volume builders are sole proprietorships, whereas only 8 percent of the medium- and large-volume builders choose to operate under such entity structure. The average remodeling firm has one office employee on payroll and operates in one or two counties. Approximately half of the remodeling firms are corporations, while 44 percent are sole proprietorships.

LAND DEVELOPMENT

Home builders vary considerably in the degree to which they directly perform all the operations it takes to develop land and build and market homes. According to NAHB's 1987 builder survey, less than half of all builders buy the raw land, install the infra-structure, construct the units, and then sell the product. Over half buy lots from other builders or developers, use subcontractors for all the construction work, sell through real estate agents, and generally only contribute their vision and organizing skills to the project.

The difficulty builders have recently experienced obtaining financing for property acquisition and development may result in land development becoming more heavily concentrated among large firms. Moreover, more stringent requirements for loans from financial institutions could mean that builders will look more often to land developers to provide financing for purchases of developed lots. Increasing fees and regulation may also cause land development to become more concentrated among well-financed specialists.

ROLE OF SUBCONTRACTORS

During the past 30 years, the role of subcontractors and professional specialists in the home building industry has increased significantly. Most builders believe that the trend toward increased use of subcontractors will continue. Framing, roofing, bricklaying, foundations, and masonry are generally done by the subcontractors on a labor-only basis, with materials provided by the builder. Other jobs, such as flooring, insulation, and painting, involve subcontracts for both labor and material.

In 1959, 31 percent of NAHB survey respondents subcontracted three-quarters or more of their construction costs. This figure increased to 55 percent by 1987. Over the same period, the share of builders subcontracting one-quarter or less of their construction costs declined from 19 percent to 14 percent. Large-volume builders tend to subcontract a larger share of the construction cost. Builders in the South use subcontractors for a larger share of construction than builders in the Northeast, Midwest, and West. NAHB's 1987 Survey of Builders indicated that subcontractors were the most relied upon source from which to obtain materials and equipment.

From the worker's point of view, a worker with a skill can generally earn more as a contractor working for a variety of customers than he could on straight salary working for a single employer. The worker may also take pride in being independent of a boss supervising the details of his work.

The home building industry (as well as the non-residential construction industry) is characterized by extensive subcontracting of the actual construction work. An NAHB survey of builders in 1987 showed that the majority of general contractors (those that build for a fee on someone else's land) and merchant builders (those that build on land they own and offer the house and land for sale together) subcontracted more than 75 percent of the total construction cost. Larger builders subcontracted an even larger share than small builders. The 1987 Census of Construction indicated that residential builders subcontracted $41 billion, or 40 percent of the value of their construction receipts. An earlier study by the Bureau of Labor Statistics found that construction of the typical home involves about 15 different subcontractor firms.

The primary reason for the extensive use of subcontractors is the episodic, uneven nature of construction and the fact that a particular type of specialist is only needed for a short period during the construction process. Moreover, the general contractor does not have either the expertise or the capacity to oversee and manage the activities of each specialist, monitoring the number of hours worked and purchasing all the materials, so the general contractor issues a subcontract based on negotiation or competitive bids and leaves it to the subcontractor to figure out how to accomplish the work, with the subcontractor often responsible for supplying the necessary building materials.

Most builders are small firms. The majority of home builder members of NAHB build less than 10 homes per year. The majority of subcontractor firms are similarly small, although it is not uncommon for a subcontractor firm to be larger than the builders for whom it works.

In 1987, there were 1.4 million establishments characterized by the Census of Construction as "special trade contractors" working as subcontractors to residential and non-residential builders, as well as serving consumers and non-construction firms directly. Establishments with payrolls, of which there were 342,000, had total receipts of $204 billion, while the 1.06 million establishments with no payroll had receipts of $34 billion. Out of total receipts, about 35 percent went toward the purchase of materials and supplies and another 7 percent was subcontracted to other subcontractor firms.

Although subcontract work may be subject to competitive bids, most builders develop long-term relationships with their subcontractors, just as consumers tend to patronize the same doctors, dentists, or lawn care firms. Even in long-term relationships and where the subcontractor has no employees, however, the relationship between general contractor and sub is different than that between employer and employee. The builder is not obligated to provide continuing employment for the sub and the sub remains liable to the builder for performance in ways an employee generally is not. There are a variety of other distinctions, many of which are reflected in the common-law tests currently used to distinguish independent contractors from employees.

Construction of a single family home involves about 1,000 hours of on-site labor, and since it takes an average of about six months to complete a house, that's equivalent to one full-time worker. Those 1,000 hours, however, may be performed by as many as 100 different workers, most of whom are proprietors or employees of subcontractor firms. Even if a general contractor knew who all the workers were and how much of the payment to subcontractors was for labor, it would be an overwhelming burden for a builder to account for tax withholding for the army of workers involved in building a home.

The 1989 NAHB remodelers survey showed that remodelers heavily rely on subcontractors. Ninety-three percent of the remodelers used subcontractors during 1988. Twenty-five percent attributed 50 to 99 percent of their dollar volume to work done by subcontractors and 5 percent subcontracted 100 percent of their dollar volume. The survey also suggested that the usage of subcontractors, rather than hiring of employees, was market, as opposed to tax, driven.

COMPLIANCE

NAHB fully supports the proposition that every American must pay his full share of Federal income tax. It is the job of the Internal Revenue Service to resolve the compliance problems in a fair and equitable manner. Improved compliance should be achieved through increasing business's compliance with the reporting requirements. NAHB opposes any governmental effort to encourage businesses to classify independent contractors as employees. We recognize that the government is concerned with improving the efficient collection of revenue with respect to errors in the classification of workers. NAHB believes that the current rules under Section 530 of the Revenue Act of 1978 provide adequate relief for construction industry taxpayers who become involved in disputes with respect to worker reclassification.

2. AMENDMENT OF THE LIKE-KIND EXCHANGE RULES TO REQUIRE THAT CODE SECTION 1031 PROPERTY BE "SIMILAR OR RELATED IN SERVICE OR USE" TO THE PROPERTY EXCHANGED, EXCEPT IN THE CASE OF CONDEMNATIONS

Section 1031 provides for nonrecognition treatment on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment. Unimproved real estate that is exchanged for improved real estate qualifies as a like-kind exchange. Except in the case of a condemnation of real estate, the proposal would narrow standard for nonrecognition of gain under section 1031 to permit nonrecognition only if the property exchanged is "similar or related in service or use", as is the standard under section 1033, pertaining to involuntary conversions of property. NAHB opposes any such change to the existing rule.

The ability to exchange property without incurring taxes encourages the exchange of rental real estate and enhances the ability of real estate owners to best match their objectives with the objectives of a rental project. With the like kind exchange rule, apartment building owners who are best suited to own and operate a particular kind of rental project will be more likely to continue owning and operating the same kind of property even if market conditions change the original property's focus. For instance, investors who operate low- or moderate-income rental projects very efficiently could find that their projects have become moderate- and middle-income because of gentrification, neighborhood change or economic growth are able, under current rules, to exchange their original project for unimproved real estate to construct a new project that better serves the market with which they are familiar.

The recent tax bill recognized the economic difficulties facing the real estate construction industry in general, and low-income housing development in particular. The proposed change would have a countervailing impact on the economic stimulative effect of the recently passed plan.

3. CAPITALIZATION AND AMORTIZATION OF CERTAIN ENVIRONMENTAL REMEDIATION COSTS

Under current law, the cost of incidental repairs which neither materially add to the value of property nor prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as a business expense. Amounts paid or incurred to materially add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or to adapt property to a new or different use, must be capitalized. Expenditures that materially increase the value of property must be capitalized. Recent IRS rulings have required capitalization of asbestos removal costs (TAM 9240004, reasoning that the property's value increased by eliminating the human health risk) and the costs of remediating PCB contaminated soil (TAM 9315004, reasoning that the activities were part of a general plan of rehabilitation which increased the value of the property).

We would be inclined to agree that capitalization treatment for hazardous waste cleanup would be proper where that cost is accounted for in determining the original sales price of the real property. However, where the buyer-builder incurs hazardous waste clean-up costs subsequent to construction of a building project, such amounts should be expensed as an expenditure which does not make the property more valuable, more useful, or longer-lived. NAHB opposes any proposal which would require that all environmental remediation costs be capitalized and amortized over a uniform period. Any proposal to clarify the treatment of environmental remediation costs by specifying costs which must be capitalized should not include unforseen hazardous waste clean-up costs.

CONCLUSION

The instant proposal with respect to section 530 would unfairly penalize compliant builders and subcontractors who have legitimately followed industry custom. The proposal to modify the like kind exchange rules would have a directly negative impact on a sustained economic recovery in the real estate sector, at the most inopportune time. The environmental remediation cost proposal must be crafted so as not to unfairly penalize real estate developers for unforseen occurrences in housing construction.

The National Association of Home Builders appreciates this opportunity to present our views on the proposed amendments.

Mr. McNulty. Next we will go to the U.S. Chamber of Commerce, Julie Gackenbach.

STATEMENT OF JULIE LEIGH GACKENBACH, DIRECTOR, TAX POLICY, U.S. CHAMBER OF COMMERCE; ACCOMPANIED BY GARY LaBRANCHE, MANAGER, ASSOCIATION DEPARTMENT

Ms. Gackenbach. Good morning, Mr. Chairman.

I am director of tax policy for the U.S. Chamber of Commerce. Accompanying me today is Gary LaBranche, manager of our Association Department.

The Chamber is the world's largest business federation, representing more than 215,000 members. On behalf of the members of our federation, we appreciate the opportunity to present our views on the various revenue proposals that are the subject of this hearing.

American business needs simplicity and stability in the Tax Code. The Chamber is concerned that merely a month after Congress enacted the largest tax increase in the Nation's history the committee is seriously considering sweeping revenue raising proposals. The business community has yet to have time to react to the recent changes. In fact, many of the provisions are yet to take effect.

Business men and women across the country are facing the seemingly daunting task of figuring out how to comply with the host of recently enacted changes. They are unprepared at this time to deal with another round of changes designed to raise revenue. As such, we are particularly pleased that the Treasury shares our concerns regarding many of these issues.

The committee today is considering proposals to change several of the foreign tax provisions. The Chamber will comment on two in particular: the proposal to eliminate the foreign tax credit and the proposal to modify the sales source rules.

The Chamber believes U.S. tax laws should not be utilized to impede investment by American companies abroad. Indeed, such investment should be viewed as a complement to exports from our domestic factories. The present system of U.S. taxation of foreign sourced income is eroding our competitive position. The committee should focus its efforts on reducing the complexity and anticompetitive nature of the current provisions rather than considering further penalizing our U.S. multinational corporations.

The foreign tax credit has been the cornerstone by which countries have eliminated international double taxation. There can be no question that the elimination of the credit for foreign income taxes would be unfair and discriminatory against U.S. taxpayers.

If U.S. tax were imposed on the full amount of foreign source income without recognizing the taxes already paid to host countries, the tax burden of U.S. multinational companies doing business in those foreign countries would be greatly increased.

For example, if the foreign country also taxes corporation earnings at the U.S. rates of 35 percent, the combined tax burden after repeal of the FTC could increase to approximately 58 percent, placing U.S. companies at a severe competitive disadvantage. As a result of the heavier tax burden, these companies would be forced to surrender their foreign markets to foreign controlled businesses and the closing of foreign markets would sharply reduce the sales of American-made goods and would unquestionably result in a further deficit in our balance of trade and a loss of American jobs.

The proposed change in the sales sourcing rules would revise the historical U.S. tax treatment of foreign sales of U.S. manufactured goods. The change would increase the cost of U.S. exports, add complexity to the code and create an accounting nightmare for U.S. companies. Exports have been one of the engines of U.S. growth over the past few years.

As the Nation struggles to maintain marginal levels of growth, we can ill afford to adopt policies such as this which will harm our export base.

Mr. Chairman, the Chamber is particularly concerned about a pattern of legislative efforts to limit ordinary and necessary business deductions. In the recently passed Omnibus Budget Reconciliation Act alone, Congress limited the deductibility of expenses for meals and entertainment, lobbying activities, executive compensation, and club dues.

The subcommittee is now considering proposals to limit the deductibility of environmental remediation and cleanup costs, advertising expenses and interest payments on corporation tax underpayments. These proposals threaten the fundamental principle of taxation—that businesses should be taxed on income rather than gross receipts.

They also substitute the judgment of politicians for those of business owners about what expenditures are appropriate and necessary to create a successful business.

The Chamber strongly opposes an attempt to require the capitalization of environmental remediation costs. We believe that legislation at this time is not necessary to clarify the tax treatment of these costs, and that the matter can and will be best handled at the regulatory and judicial levels. Any uncertainty with respect to the tax treatment of these costs has arisen as a result of two rulings recently issued by the IRS requiring that such costs be capitalized.

The weight of authority however supports the deductibility of such costs. Therefore, legislation is not necessary to resolve any uncertainty at this time.

The Chamber also opposes proposals to disallow deductions for all cleanup costs and compensatory damages associated with an oil or hazardous substance spill. No one intends to cause environmental damage. However, accidents can and do happen. When they occur, the cleanup costs and compensatory damages represent real cost to the taxpayers, expenditures which are ordinary and necessary in the course of business and which reduce profit.

Like proposals to capitalize remediation expenses, denying deductions for these cleanup costs sends the wrong message by discouraging the very cleanup expenditures and related settlements which we hope to encourage. The punitive goals of such proposals are better effectuated by existing penalties under Federal and State environmental laws, both civil and criminal.

Use of the Tax Code to further penalize these companies is both inappropriate and unnecessary.

The committee is also considering two proposals relating to corporate tax underpayments. The first proposal would deny corporations an income tax deduction for interest paid and the second would increase the tax rate on under payments to an unspecified rate. The Chamber opposes both of these proposals.

The Internal Revenue Code is nothing if not complex. We believe American taxpayers, both individuals and businesses, make every effort to comply with tax laws. We believe that increasing the interest rate and denying interest deductions would cause great hardship.

The committee is also considering a proposal to require that taxpayers amortize a portion advertising costs over a period of years. Effective advertising is one of the hallmarks of an aggressive and prospering business. Through creative media, sales, and promotional campaigns, innovative products are introduced and new markets are created.

As trade barriers around the world come down, the Nation's business community is now poised to take advantage of these newly open markets. Advertising will be a principal medium by which foreign consumers will become acquainted with the variety and quality of American products.

Mr. Chairman, it just doesn't make sense to stifle the competitiveness of U.S. firms at this crucial juncture.

Finally, Mr. Chairman, the Chamber is concerned about proposals to stifle lobbying efforts. The committee is considering a proposal to impose a 30 percent excise tax on the lobbying expenditures of noncharitable, tax-exempt organizations.

The U.S. Chamber on behalf of its 42 associations and Chambers of Commerce opposes the proposal. Taxing the lobbying activities of these organizations crimps the fundamental right of citizens to make their views known to their elected officials. Ordinary citizens, including small businesses, depend on associations to make sure their voice is heard in Washington.

Advocacy by associations has contributed to responsible and informed solutions in many areas of public policy including equal rights, employee-employer relations, public health and nutrition, and protection of the environment.

The proposal before the committee will have a dampening effect on the work of associations because it incorporates the expansive definition of lobbying contained in the code section 162(e). Thus, the excise tax would discourage some of the very nonlobbying activities which Congress looks to the association community to provide, including nonpartisan analysis and technical advice.

It is time that we stand up for the work that associations do in Washington. If my appearance here or the appearance of the other members of my panel have been helpful to the committee, this is a testament to the value of associations in the public policy process. The excise tax proposal before the committee would discourage such contributions.

Mr. Chairman, thank you for allowing us to present our views and we will be happy to answer questions.

[The prepared statement follows:]

STATEMENT
on
MISCELLANEOUS REVENUE PROPOSALS
before the
SELECT REVENUE MEASURES SUBCOMMITTEE
of the
HOUSE COMMITTEE ON WAYS AND MEANS
for the U.S. Chamber of Commerce
by
Julie Leigh Gackenbach
September 21, 1993

Mr. Chairman and members of the committee, good morning. I am Julie Leigh Gackenbach. The U.S. Chamber of Commerce is the world's largest business federation representing more than 215,000 member businesses, 1,200 associations, 3,000 state and local chambers of commerce, and 68 American Chambers of Commerce abroad. On behalf of the members of the Chamber Federation, we appreciate this opportunity to present our views on the various revenue proposals that are the subject of this hearing. I have provided the full text of our comments and respectfully request that they be included in the hearing record.

American business needs simplicity and stability in the federal code. The U.S. Chamber is concerned that merely a month after Congress enacted the largest tax increase in our nation's history that the committee is seriously considering such sweeping revenue raising proposals. The business community has not had time to react to the recent changes; in fact, many of these provisions have yet to take effect. Businessmen and women across the country are facing the seemingly daunting task of figuring out how to comply with the host of recently enacted changes. They are unprepared at this time to deal with another round of tax changes designed to raise federal revenue.

FOREIGN TAX PROVISIONS

Many of the foreign tax provisions of the Internal Revenue Code, and the proposals before the committee today, are based on the fallacious premise that investment overseas by U.S. multinational corporations leads to a loss of jobs for the American work force and less revenue for the federal Treasury. This belief has resulted in U. S. tax policies which impose higher burdens on the international operations of U.S. corporations than those imposed by our foreign trading partners on their multinational corporations. U.S. tax laws should not be utilized to impede investment by American companies abroad. Indeed, such investment should be viewed as a complement to exports from domestic factories. The present system of U.S. taxation of foreign-sourced-income is eroding the competitive position of U.S. businesses in the international marketplace. The committee should focus its efforts on reducing the complexity and anti-competitive nature of the current provisions rather than considering further penalizing U.S. multinational corporations.

American multi-national corporations (according to the Department of Commerce) exported $98.4 billion dollars worth of goods, and accounted for nearly one-fourth of the $400.8 billions dollars worth of merchandise exports during that year.

Proposal to Eliminate the Foreign Tax Credit

The committee is considering a proposal to eliminate the foreign tax credit. All industrialized nations of the world operate under the principle that the country wherein income is earned has the first right to tax that income. Many of those same nations, including the United States, also tax the worldwide income of companies incorporated within their borders, regardless of the source of that income. The foreign tax credit has been the cornerstone by which these countries have eliminated international double taxation.

There can be no question that the elimination of a credit for foreign income taxes would be unfair and discriminatory against U.S. taxpayers. If U.S. tax were imposed on the full amount of foreign-sourced-income without recognizing the income taxes already imposed by the host country in which the income was earned (which would be the case if the foreign tax credit (FTC) were eliminated and replaced with a deduction), the tax burden of U.S. multinational companies doing business in those foreign countries would be greatly increased. For example, if the foreign country also taxes corporate earnings at the U.S. rate of 35 percent, the combined tax burden on foreign earnings after repeal of the FTC would increase to approximately 58 percent. Since local companies in those foreign jurisdictions would not be subject to as heavy a tax burden on their own operations, U.S. companies would be placed at a severe competitive disadvantage. As the eminent former Assistant Secretary of the Treasury Stanley Surrey testified in 1967: "American investment would not proceed at all without the foreign tax credit because then ... two taxes would be imposed and the overall burden of two taxes would be so great that international investment would practically cease." This comment is as true today as when it was made over 25 years ago.

Enactment of a proposal to treat foreign income taxes as deductions instead of permitting a foreign tax credit would have a disastrous effect on U.S. corporations engaged in international business. As a result of the heavier tax burden, these companies would be forced to surrender their foreign markets to foreign-controlled businesses. The closing of these foreign markets would sharply reduce the sales of American-made goods and would unquestionably result in a further deficit in our balance of trade with other industrialized countries, leading to a loss of American jobs.

Committee Chairman Rostenkowski recognized the importance of the foreign tax credit in a speech to the Chicago Council on Foreign Relations in 1976, asserting that:

> I am firm in my belief that the foreign tax credit is the key to U.S. international tax policy, and should, under no circumstances, be repealed or modified in any fundamental way. I say this simply because it seems to me that if foreign governments tax the foreign income of U.S. multinational corporations, and then the U.S. taxes that income in addition, double taxation results. The tax burden of this double taxation cannot help but impede international trade and international movement of capital. For this reason, as one who strongly believes in expanding international trade and unrestricted capital movement, I can see no circumstances under which I would recommend any fundamental change in the foreign tax credit.

Although a number of changes have been made which have lessened the benefits of the foreign tax credit since Chairman Rostenkowski made this statement, the reasons for the fundamental principle of retaining the foreign tax credit are even more persuasive today than they were in 1976. The world has moved to a global economy and industrialized nations recognize the economic necessity and benefit of permitting their domestic corporations to operate abroad without bearing a higher tax burden than their foreign competitors. Accordingly, if the United States is to participate in world-wide trade and the economy and reap the benefits provided to our nation, it is essential that the foreign tax credit be kept intact.

Proposal to Revise the Inventory Sourcing Rules

The committee is considering a proposal to reduce the amount of foreign source income derived from sales to related parties. Under current law, the income from the sale of domestically manufactured goods in foreign markets is treated partially as U.S.-sourced income and partially as foreign-sourced income. Generally, 50 percent of such income is apportioned on the basis of the location of the assets used in production and 50 percent on the basis of the place of sale. Therefore, if a U.S. manufactured good is sold to an unrelated foreign buyer for $100, $50 of that income generally would be treated as U.S.-source income and $50 would be treated as foreign-source income. However, if the U.S. multinational corporation makes a sale to its foreign sales subsidiary, only the portion of the income related to the sale is affected by the split. Thus, if the U.S. parent sells a product to its foreign subsidiary for $70 and the foreign subsidiary makes a sale to the end user for $100, income would be sourced $35 (50% of $70) U.S.-source and $65 (50% of $70 and 100% of $100 -$70) foreign source.

The proposed change would revise the historical U.S. tax treatment of foreign sales of U.S. manufactured products and would increase the cost of U.S. exports. The change would particularly hurt U.S. manufacturers who use a foreign subsidiary to market their exports. Exports have been one of the engines of U.S. growth over the past few years. As the nation struggles to maintain marginal levels of growth, we can ill afford to adopt policies such as this which would harm the U.S. export base.

In addition to the negative effect on exports and U.S. jobs, the proposal would greatly increase the compliance burden of U.S. manufacturers and add to already overly complex foreign tax rules. The combined calculation is complex, and administration would require some form of tracing rule as the products move through the distribution chain - creating an accounting nightmare.

ENVIRONMENTAL PROVISIONS

Capitalization of Environmental Remediation Costs

The committee is considering a proposal to require that all environmental remediation costs be capitalized and amortized over a uniform period, rather than deducted as current expenses. The Chamber strongly opposes an attempt to require the capitalization of environmental remediation costs. We believe that legislation at this time is not necessary to clarify the tax treatment of environmental cleanup costs, and that the matter can and will be best handled at the regulatory and judicial levels.

Congress has enacted amortization provisions in the past either to permit taxpayers to recover capital expenditures which would not be subject to the allowance for depreciation because they lack an ascertainable useful life or to permit such expenditures to be recovered over a shorter period than would be allowed under the general depreciation rules. The enactment of legislation requiring the capitalization and amortization of environmental cleanup costs is not necessary to eliminate uncertainty with respect to their tax treatment. Any uncertainty with respect to their tax treatment has arisen as a result of two rulings recently issued by the Internal Revenue Service (IRS) requiring that such costs be capitalized (TAM 9315004 - 12/17/92 and TAM 924004 - 06/19/92). The weight of authority, however, supports the deductibility of such costs. In general, they do not add to the value of the property which is subject to remediation, extend its useful life, or adapt it to a new or different use, criteria established in Treasury Regulation 1.263(a)-1(a). Because environmental costs are not capital and the weight of authority supports the treatment of such costs as currently deductible repair expenses, legislation is not necessary to resolve any uncertainty.

Congress has historically provided more favorable cost recovery to encourage activities which it believes are socially beneficial. Examples include accelerated amortization periods for certain assets and current expensing treatment for expenditures which would ordinarily have been depreciable over a period of years. An example of the latter case is the Section 179 expensing provision, which was expanded in the Omnibus Budget Reconciliation Act of 1993. Examples of provisions permitting more favorable amortization include Section 174 (research and experimentation expenditures); Section 169 (pollution control expenditures); Section 190 (expenditures to remove handicapped accessibility barriers); Section 188 (expenditures for child care facilities); and Section 167(k) (rehabilitation of low-income housing), to name a few. In each instance, Congress sought to encourage spending by permitting more favorable cost recovery. However, in the case of environmental cleanup costs, the weight of the evidence clearly favors current deductibility, and as such, the proposed change represents a disincentive to cleanup. As the business community works to meet the nation's environmental goals, requiring remediation expenses to be capitalized and amortized would undercut these important efforts by discouraging environmental cleanup expenditures.

Deny Deductions for Certain Hazardous Waste Cleanup Expenses

The Chamber also opposes proposals to disallow deductions for all cleanup costs and compensatory damages associated with an oil or hazardous substance spill caused by a company found to have unlimited liability under the Oil Pollution Act (OPA) or the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA). Under current law, expenses related to cleaning up hazardous waste spills are generally considered to be ordinary and necessary business expenses and therefore deductible.

No one intends to cause environmental damage; however, accidents can and do happen. When they occur, the cleanup costs and compensatory damages represent real costs to the taxpayer, expenditures which are ordinary and necessary in the course of business and which reduce corporate profit. Like proposals to capitalize remediation expenses, denying deductions for these cleanup costs sends the wrong message by discouraging cleanup expenditures and related settlement payments. The punitive goals of such proposals are better effectuated by the existing penalties under federal and state environmental laws, both civil and criminal. Use of the tax code to further penalize these companies is inappropriate and unnecessary.

COMPLIANCE PROVISIONS

Deny Deductions for Interest Payments on Corporate Tax Underpayments and Raise the Interest Rate on Corporate Tax Underpayments

The committee is considering two proposals relating to corporate tax underpayments. The first proposal would deny corporations an income tax deduction for all interest paid or accrued on tax obligations. The second proposal would increase the tax rate on corporate underpayments to an unspecified rate. The Chamber opposes both of these proposals.

The Internal Revenue Code is nothing if not complex. We believe American taxpayers, both individuals and business, make every effort to comply with the tax laws. However, you, as members of the Ways and Means Committee are aware, even seasoned tax professionals, when given the same set of circumstances will often differ greatly on the proper amount of tax due. In fact, due to the backlog in promulgating regulations, taxpayers are often left to file returns based on the their best estimate of what the regulations will require. As such, well-meaning businessmen and women are often faced with bills for underpayments of tax liability, plus interest.

Because of Internal Revenue Service backlogs or delays, these tax bill may come several years after the tax year in question, resulting in hefty interest charges. Some of the nation's larger corporations are just now closing their tax years for the early 1980s. As such, they could face interest charges for ten or more years. While these taxpayers will pay their tax due and an appropriate interest charge, we believe that increasing the interest rate or denying the interest deduction would cause great hardship on taxpayers and would likely undercut the spirit of the committee's work on a Taxpayer Bill of Rights II.

ACCOUNTING PROVISIONS

Treatment of Advertising Expenditures

The committee is considering a proposal to require that taxpayers amortize a portion of their advertising costs over a period of years. Currently, advertising expenditures are fully deductible if they otherwise qualify as ordinary and necessary business expenses.

The Chamber opposes this latest in a wave of efforts to limit ordinary and necessary business deductions. In the Omnibus Budget Reconciliation Act of 1992 alone, Congress limited the deductibility of meals and entertainment expenses (beyond the limitations imposed in 1986), lobbying expenses, executive compensation, and club dues. Like the lobbying excise tax proposal discussed below, these "reforms" have great populist appeal; however, they undercut a fundamental principal of taxation--that businesses should be taxed on income, rather than gross receipts. They also substitute the judgement of politicians for those of business owners about what expenditures are likely to advance sales and profits. Excessive or inappropriate expenditures hurt the bottom line. This fact, coupled with corporate fiduciary rules, shareholder action against prodigal management, and existing Treasury rules and substantiation requirements, effectively limit opportunities for abuse.

The effort to limit the deductibility of advertising expenses is particularly troubling. Effective advertising is one of the hallmarks of an aggressive, prospering business. Through creative media, sales, and promotional campaigns, innovative products are introduced and new markets are created. The integrated nature of these campaigns raises administrative and accounting concerns if advertising costs are required to be capitalized. For example, when sales representatives are provided with logo T-shirts, is this a sales, promotional, or advertising expense?

Likewise, the theoretical basis for amortizing advertising costs--that advertising provides the firm with long-term benefits--is not sound across the varied spectrum of advertising. In some cases, an advertising campaign will be geared to the creation of long-term brand loyalty, raising an analogy to goodwill (amortizable in the wake of the U.S. Supreme Court's decision earlier this year in *Newark Morning Ledger).* In many cases, however, advertising has more immediate and short-term aims, such as introducing a new product, or promoting a Labor Day sale. In a 1990 study, Kenneth Arrow and George Stigler concluded that virtually all of the benefits of the typical advertising campaign dissipate within one year.

As trade barriers around the world come down, the nation's business community is now poised to take advantage of newly open foreign markets. Advertising is the principal medium by which foreign consumers will become acquainted with the wide array of quality American products. Mr. Chairman, it doesn't make sense to stifle the competitiveness of U.S. firms at this crucial juncture.

TAX EXEMPT ENTITIES PROVISIONS

Lobbying Expenditure Excise Tax

The committee is considering a proposal to impose a 30 percent excise tax on the lobbying expenditures of non-charitable, tax-exempt organizations. The U.S. Chamber, on behalf of the 4,200 associations and chambers of commerce it represents, opposes this proposal.

Taxing the lobbying activities of tax-exempt organizations crimps the fundamental right of citizens to make their views known to their elected officials. Most merchants, shopkeepers, entrepreneurs, and professional and small business owners do not have the resources to open a Washington office, to continually monitor the stream of legislation and regulations that affect them, or even to visit Capitol Hill. They must spend their time and resources making a living. These citizens depend on associations to make sure their voice is heard in Washington. Seven out of ten Americans belong to at least one association. They pay an average of $168 for individual annual dues and $560 in corporate dues to support the varied activities of their associations (lobbying accounts for an average of 6 percent of the budgets of associations).

Associations have traditionally set industry standards, established self-regulatory mechanisms, and provided education and training for members. Increasingly, associations are being asked to play a more active role in a complex commercial and policy environment. When regulations are contemplated, when legislation is drafted, when trade policy is discussed, or when governmental research needs to be transferred to the private sector, lawmakers seek out associations for help and advice. Through data, analysis, and case studies, associations allow members of Congress and their staffs to better understand the complexities of the sectors they represent. Advocacy by associations has contributed to responsible and informed solutions in many areas of public policy, including equal rights, employee-employer relations, public health and nutrition, and protection of the environment. The U.S. Supreme Court has recognized the value of these organizations to society, noting in *NAACP v. Alabama*, 357 U.S. 449 (1958), that "effective advocacy of both public and private points of view, particularly controversial ones, is undeniably enhanced by group association."

The proposal before the committee will have a particularly dampening effect on the work of associations because it incorporates the expansive definition of lobbying contained in Code Section 162(e). Thus, the excise tax would discourage some of the very non-lobbying activities Congress looks to the association community to provide, including non-partisan analysis and technical advice provided in response to a written request by congressional committees.

The political backdrop for this type of proposal is well-known. The villainization of lawmakers and government relations professionals has advanced the careers of numerous politicians and talk show hosts. It has already compelled Congress to enact an administrative nightmare for the sake of symbolism: the rules limiting the deduction for lobbying expenses included in the Omnibus Budget Reconciliation Act of 1993. But like many "reforms" played out for a populist audience, anti-lobbying rules will miss their purported targets, and instead undercut the conscientious work of thousands of tax-exempt organizations working for responsible change in Washington. As columnist David Broder noted in an April 25, 1993 piece in the *Washington Post*:

> Reformers couch their proposals in terms of eliminating pernicious influences on politics and government, but they rarely acknowledge that the changes they push would also redistribute power.... If lobbying were outlawed or curbed, who would lose influence--the average small employer who belongs to the Chamber of Commerce, or Ross Perot?.... The winners would once again be the elite.

Clearly, tax-exempt organizations are not the only institutions to take positions on public-policy issues. Wealthy or influential individuals, newspapers, magazines, and corporations regularly urge their audiences to take action on legislative issues. To further burden the political activities of tax-exempt organizations is an inconsistency which raises fairness and equal protection concerns.

It is time that we stand up for the work that we associations do here in Washington. If my appearance here, or the appearance of other members of this panel has been helpful to the committee, this is a testament to the value of associations to the public policy process. The excise tax proposal before the committee would discourage such contributions and undercut policymaking for the sake of politics.

Mr. Chairman, thank you for allowing us to present our views to the committee. We would be happy to answer any questions.

Mr. McNULTY. Thank you very much for your testimony. Now we will go to the American Institute of Certified Public Accountants, Pamela J. Pecarich.

STATEMENT OF PAMELA J. PECARICH, CHAIRMAN, TAX LEGISLATIVE LIAISON COMMITTEE, TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Ms. PECARICH. Thank you members of the committee and staff. I am Pam Pecarich, chairman of the Tax Legislative Liaison Committee of the American Institute of Certified Public Accountants. Our chairman, Harvey Coustan, could not be here today so I am privileged to take his place in representing our 310,000 members, most of whom advise on tax matters and prepare returns for millions of taxpayers. I am also director of tax policy for Coopers & Lybrand here in Washington, D.C.

We particularly appreciate the efforts of your committee in scheduling this series of hearings on these various revenue measures in order to allow the public an opportunity to comment. However, we believe many of the items on the list submitted for this hearing should be rejected in the name of sound tax policy and tax administration. For some years, the AICPA has expressed its concern that tax legislation is being driven significantly more by revenue needs to pay for other proposals than by tax policy considerations.

There are any number of items on this agenda that fit such a description. And in many cases, the revenue gain would seem to be quite small relative to the added compliance burdens or other complexities that the proposals would entail. The tax writing committees of Congress must be constantly concerned with inordinate complexity and reporting burdens because of the adverse effects these factors have on compliance by taxpayers.

A number of the proposals would revise provisions that were extensively debated, negotiated, and ultimately passed in the revenue title of the 1993 act. In essence, these changes are proposed before the OBRA provisions have even gone into effect. We remind the committee that change itself is a source of complexity and we do not believe it unreasonable to expect stability in our tax laws that last more than a few months.

As a case in point, the estimated tax provision of the 1993 act represents a badly needed simplification of the individual estimated tax system that itself was made substantially more complex from a last-minute change in 1991 unemployment insurance legislation.

OBRA thus provides that individuals with adjusted gross incomes of 150,000 or more will have to use 110 percent of last year's tax as a safe harbor for paying current year's estimates rather than the 100 percent used by all other taxpayers. This change was the result of substantial discussion and negotiation over a 2-year period to reach what was believed to be a fair and workable solution.

I might add that it was also a revenue raiser in the 1993 legislation. Now it is suggested that further changes be made to the new safe harbor before it even takes effect. Let us point out that increasing the safe harbor is inappropriate because it will diminish its simplification benefit. It will encourage many small businesses and individuals to opt out of the safe harbor rule by doing more complex calculations three and four times a year.

Another worrisome theme we see represented in these proposals is the growing tendency to chip away at the net income concept of taxation by disallowing portions of bona fide trade business expenses. This tendency may be seen today in proposed disallowance of a portion of advertising expenses, disallowing a deduction for corporate interest on tax underpayments, limiting deductions for valid business auto expenses, denying a deduction for environmental cleanup costs and damages.

Such proposals are unfair to many taxpayers. They move us away from a sound definition of taxable income and increase tax law complexity. For example, a current deduction for short-lived expenses such as advertising is well supported in tax and accounting theory, while limiting the deduction will cause the IRS, the Treasury, the courts, and countless taxpayers great difficulty in defining advertising and related costs subject to capitalization. We at the Institute have consistently opposed efforts to erode the net income consent and reiterate that the slow move toward the gross income tax must be halted.

We oppose on policy grounds two other significant proposals for change: replacement of the foreign tax credit with a deduction and repeal of the taxable income limit for S Corporation built-in gains tax. The foreign tax credit has been in our tax system since 1921 and is the underpinning of our approach to taxing the worldwide income of U.S.-based companies. To casually suggest a change to this provision outside of the context of a reconsideration of our system of international taxation is alarming. This proposal should be rejected.

The taxable income limit included in the built-in gains tax for S corporations is designed to defer payments for corporations in economic distress who have no wherewithal to pay the tax. The proposed change would be a significant reversal of past Congresses' view of this tax and should be dropped from consideration.

In conclusion, our written statement outlines our positions on several other proposals as well. We were unable to finish sufficient review to comment on all of the provisions particularly because some of the earlier descriptions of the proposals were not sufficiently detailed. However, we sincerely stand ready to assist this committee in its work and hope that you and your staff will call on the Institute and its staff if you need additional information on any of these matters or want to solicit the views of any of our technical committees.

Thank you, Mr. Chairman and members.

[The prepared statement follows:]

TESTIMONY OF PAMELA J. PECARICH
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Introduction

Good morning. I am Pam Pecarich, Chairman of the Tax Legislative Liaison Committee of the American Institute of Certified Public Accountants. Unfortunately, our Executive Committee Chairman, Harvey Coustan, is unable to be with you today, but I am privileged to replace him in representing our 310,000 members. The AICPA is the national, professional organization of CPAs of whom many (if not most) advise clients on tax matters and who prepare returns for millions of taxpayers. We, also, very much appreciate the opportunity to present our views. We have not had the time to look at each proposal in detail, and many of them are not clear enough on their face for us to understand fully, but we have focused on a few proposals as the basis of our comments.

Mr. Chairman, thank you for your efforts in scheduling a series of public hearings on these various revenue measures. Allowing the public an opportunity to comment on the proposals can only further the interests of sound tax policy and administration.

General Comments

We believe many of the items in the list submitted for this series of hearings should be rejected without substantial discussion. For some years, the AICPA has expressed its concern that tax legislation is being driven significantly more by revenue needs to pay for other legislative proposals than by tax policy considerations. There are any number of proposed tax changes on your agenda that seem to fit such a description, and in most instances the revenue increase from a particular proposal is not all that large. However, we are concerned that we have had great difficulty (or no luck at all) in even determining who is the proponent of specific proposals, much less the policy rationale behind proposing most of them. What is left, then, is a perception that many of these items are being suggested to raise revenues the use of which will be made known at a later point.

A number of the proposals take provisions that were debated, negotiated and ultimately passed in the tax portion of the 1993 Budget Reconciliation Act; but then moves the 1993 Act provision one or two steps further. We find this back-door approach for getting still more revenue from provisions that took seven months to craft originally, to be singularly inappropriate. For example, the badly-needed simplification of the individual estimated tax system (included as part of the 1993 Act) provides that individual taxpayers with adjusted gross incomes exceeding $150,000 will have to use 110 percent of last year's tax as a safe harbor for paying current year estimated taxes, rather than the 100 percent used by all other individuals. That change was the result of substantial discussion and negotiation, and resulted in what was seen as a "fair" solution to a problem that had been caused from a short-term need to raise a certain amount of revenue back in 1991. The process of correcting the difficulties caused by that casual 1991 change (made without benefit of hearings or discussion) took almost two years. Now, someone is suggesting that the 110 percent safe harbor be raised to 115 percent, even before the 110 percent safe harbor goes into effect. Analogous points may be made about withholding on bonuses, increased from 20 percent to 28 percent in the 1993 law and now proposed to rise to a 36 percent rate before the 28 percent has even started.

We have also commented, over some years (most recently this spring to both the Ways and Means and Finance Committees concerning certain of the proposals for the 1993 Budget Reconciliation Act) about the growing tendency to chip away at the net income concept of taxation by disallowing portions (ranging up to 100 percent) of items previously deductible - especially bona fide trade or business expenses. That approach continues in the current list of proposed items (e.g., disallow a portion of advertising expenses, disallow corporate interest on tax deficiencies, limit otherwise valid business deductions for trips beginning at home). We have recommended, consistently, that the slow move toward a tax on gross income needs to be halted, and we reiterate that view here.

Finally, let us - once again - put in a plea for considering simplification as you enact tax legislation. Putting still more thresholds for partial nondeductibility into the law (see our comments in prior paragraph) gains relatively little revenue but adds complexity. Requiring meals and entertainment substantiation for expenditures over ten dollars (as opposed to today's $25) will bring in virtually no revenue but will add millions of required hours a year to the recordkeeping process of American business. The changes in accounting and reporting systems will impose burdens completely disproportionate (for most of the items on the hearing agenda) to the small amount of additional revenues being raised by those items.

We continue to remind the Congress of the limited audit resources in the Internal Revenue Service. Complexity as a pervasive force in our tax system, combined with limited governmental resources for coping with that complexity, leads to growing disrespect for a self-assessment system relying on voluntary compliance.

With respect to your present series of hearings, we believe many of the proposals before this subcommittee add complexity while raising only limited revenue. The hearings were announced within only weeks of enactment of the 1993 Budget Reconciliation Act, and we believe that individuals, businesses and practitioners should have an opportunity to live with the just-enacted law before numerous changes begin being made to it. Change, in and of itself, is a source of complexity, and we do no believe it is unreasonable to ask for stability in our tax laws that lasts more than a few months.

Thus, we do not find much to be enthusiastic about in the list of proposals for these hearings. We are commenting on a number of them, but in relatively brief fashion. Some of our comments will merely refer back to one of these general points, others will focus on specific policy issues. And, prior to enacting any of the large number of revenue raisers in these proposals, we believe it only fair to know whose proposals they are and what they are intended to pay for.

A Proposal to Increase Estimated Tax Payments Under the Safe Harbor Method to 115 Percent of Last Year's Tax Liability For Individuals with AGI Over $150,000

The AICPA has worked with Congress to eliminate the harsh and unworkable estimated tax provision that was enacted at the end of 1991. The '93 Act contains a simple, fair, and administrable solution that was widely supported and has been highly praised. Before it even goes into effect, however, a revenue raiser is being proposed. We strongly oppose this proposal because the estimated tax issue was raised by the AICPA only to correct a very serious mistake, has now been adequately addressed, and this troublesome area should not be reopened.

Small businesses agreed to a 110% safe harbor as a simple and safe alternative to the very complicated rules which preceded passage of the law this summer. Increasing the safe harbor to 115% or anything above 110% will result in many small businesses and individuals opting out of this safe harbor rule and having to do much more complicated tax calculations three and four times a year as an alternative.

A Proposal to Repeal the Section 1374(d)(2)(A)(ii) Taxable Income Limitations on the recognition of Built-in Gain of S Corporations

This proposal would remove the taxable income limitation used by S corporations when computing their built-in gains tax liability. The limitation defers the payment of built-in gains tax in years the corporation may be suffering real economic losses, and may not have the resources to pay the tax. The proposed change would be a significant reversal of Congress' application of this tax.

Section 1374 is designed to maintain a double-level tax on appreciation in assets that accrued in a corporation before it elected S corporation status. To accomplish this, section 1374 imposes a potential corporate-level tax on asset dispositions over the ten years following conversion to S corporation status. The amount of recognized built-in gain on which an S corporation must pay tax in any year is limited to the corporation's taxable income for that year.

Recognizing taxpayers could abuse such limitations, Congress included a suspense account mechanism in section 1374 which causes any gain not taxed by virtue of the taxable income limitation to be taxed the following year, subject to a taxable income limitation in that year. Only after the passage of the ten years following conversion to S corporation status does the corporation's exposure to the built-in gains tax expire.

The tax policy justification supporting the taxable income limitation and its predecessor, the "net income limitation," is twofold. First, without such a limitation, an S corporation is in a worse position than a similarly positioned non-S corporation, which is not taxed in excess of its income. Filing an S election should not result in an acceleration of the corporation's tax liability.

Congress was clearly embracing the "wherewithal to pay" concept when it modified section 1374 in 1988. In its report on the 1988 Act, the Ways and Means Committee noted it "believes it is appropriate not to impose the built-in gains tax in a year in which the taxpayer experiences losses." The AICPA believes this approach is the proper one and a wherewithal mechanism must remain in section 1374. To do otherwise would expose more than 1.5 million S corporations, the vast majority of which are small businesses, to tax assessments in situations in which they lack sufficient resources to manage their ongoing operations.

Last year, this proposal was dropped out of H.R. 5646. Earlier in 1988, this idea was proposed for inclusion in S.2238, the Technical Correction, bill under consideration that year. Again, the matter was dropped. The taxable income limitation is good tax policy. It should be maintained and its proposed repeal should be removed from the bill.

A Proposal to Change the Foreign Tax Credit to a Deduction

The U.S. has adopted a posture of "capital export neutrality" in taxing foreign source income of U.S. corporations; i.e. U.S. investors bear an equivalent tax burden regardless of the country in which that income is earned. Other objectives that have fashioned tax policy in the international context are: (1) preservation of the U.S. tax base, (2) consistency with international norms, (3) efficient allocation of resources (not hampered by the tax law), and (4) allowing U.S. companies to successfully compete in the international marketplace. All of these have been reflected for generations in U.S. tax treaty negotiations.

U.S. persons are taxed on their worldwide income, i.e. taxable income from both U.S. and foreign sources. To avoid international double taxation of foreign source income, payments of foreign taxes have, since 1921, been allowed as credits against a U.S. person's tax liability. The foreign tax credit is one of two internationally accepted norms for relief of double taxation - the other being exemption of foreign source income.

The foreign tax credit is limited to U.S. tax liability on foreign source income so that foreign taxes paid at higher than the U.S. rate cannot offset U.S. tax on U.S. source income. Moreover, the foreign tax credit is further reduced by the allocation and apportionment of expenses against foreign source income, and the separate limitation categories imposed by current law. The latter restriction is to prevent cross-crediting of high foreign taxes and the erosion of the U.S. tax base.

By allowing a credit (with limitations described above), rather than a deduction, for taxes paid other nations, the United States has - for over 70 years - recognized the concept that other sovereign nations' income taxes are considered to be on a par with our own. If that policy made sense in the early 1920s, it makes even more sense in the early 1990s in which our economy, our businesses, and our tax system must reflect the realities of a multi-national (and highly competitive) world. To artificially increase the cost of U.S. businesses operating outside the United States would have serious and severe economic and financial consequences. For U.S. business to remain even reasonably competitive, should this provision be adopted, would require massive negotiations with all our tax treaty partners to undo the unilateral damage that would otherwise be caused.

This proposal should be totally rejected.

A Proposal to Freeze the Standard Mileage Rate Used to Determine Deductible Automobile Expenses Incurred for the Business Use of Such Vehicles at the 1993 Level for the 1994 Taxable Year, and Thereafter, to Round Down the Amount Computed by the IRS to the Nearest Whole Cent. A Proposal to Limit the Business Mileage Deduction for Trips Beginning at the Taxpayer's Home to Mileage in Excess of 10 Miles

Freezing or limiting the use of the standard mileage rate actually works against tax simplification. Use of the standard rate is simple and is designed to be an alternative to the recordkeeping that would be required to deduct actual expenses. The standard rate is computed annually by the IRS to reflect realistic costs of driving a vehicle. To the extent that the standard mileage rate does not adequately reflect costs because of this proposal, more taxpayers will use actual expenses with the related additional recordkeeping and complexity. In addition, these proposals seeks to deny taxpayers a deduction for the full amount of expenses incurred in the business use of an automobile. The proposal to limit the business mileage deduction for trips beginning at the taxpayer's home to mileage in excess of 10 miles adds recordkeeping and complexity. As previously stated, such a limit or disallowance of legitimate ordinary and necessary expenses is not appropriate.

A Proposal to Repeal the Safe Harbor Under Section 530 of the Revenue Act of 1978, Relating to the Classification of Workers as Independent Contractors, for Construction Industry Employees

The Revenue Act of 1978 provided definite rules to reduce the controversy in classifying workers as employees or independent contractors. The Act sought to avoid reclassifications of workers whom taxpayers treated as independent contractors in good faith and with a reasonable basis in court decisions, IRS audit acquiescence, or long-standing recognized practice for a significant segment of the relevant industry. The taxpayer was also required to have fulfilled tax filing and reporting requirements for independent contractors.

We have not seen any evidence of widespread abuse, and would discourage Congress from re-opening this area of controversy and complexity, unless a more comprehensive approach is taken.

A Proposal to Disallow Deductions for Compensatory Damages Under Certain Environmental Laws and a Proposal to Clarify the Treatment of Environmental Remediation Costs by (1) Specifying the Types of Such Costs That Must be Capitalized, Or, Alternatively, (2) Requiring that all Such Costs be Amortized Over a Uniform Period of Years.

The tax treatment of environmental compensatory damages and remediation costs is extremely complex and has tremendous implications for businesses (including many small businesses) and the environment. We believe that these proposals should be considered separately from the other provisions being discussed today. Resolving these issues will require careful study and intensive legislative consideration.

A Proposal to Require that a Portion of Advertising Expenses be Capitalized and Amortized Over a Period of Years

This proposal is unfair to many taxpayers and will increase complexity in the tax law.

Like other business expenses, advertising costs are incurred to produce revenue and should be deductible if taxpayers are to perceive our system as being fair. These costs generally affect the current year's revenue or possibly part of the next, and should be currently deductible. To the extent that there is only a slight advertising benefit beyond the current period, allocating the costs to additional periods adds complexity that is not worth the revenue. To the extent that extraordinary advertising affects later periods, the law already requires capitalization. As stated by the Tax Court in Manhattan Co. of Virginia, Inc., 50 T.C. 86 (1968):

> The reason advertising expenses are [currently expensed] is that these expenses are generally of a yearly recurring nature resulting from a regular activity of a taxpayer which produces new business on a relatively consistent basis each year. ... Under unusual circumstances, where extraordinary advertising has developed assets with a useful life extending over a period of more than one year, this Court has held that the expenditure should be capitalized and the cost of such advertising amortized over the period of the useful life of the asset developed.

The loss of the current deduction will have an adverse impact on newspapers, commercial television, and advertising agencies which provide advertising for businesses. Businesses that rely heavily on advertising will be taxed more heavily and will have to pay more tax, reduce advertising, or shift to other forms of marketing.

The proposal would add substantial complexity as the Internal Revenue Service, the Treasury Department and the courts try to define advertising and related costs subject to capitalization. Interestingly, even after the U.S. Supreme Court's decision, in INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039 (1992), in which the government was given added flexibility to capitalize costs that benefited future tax periods, the Internal Revenue Service confirmed (in Revenue Ruling 92-80) that advertising expenses would, in general, continue to be currently deductible.

A Proposal to Tax Political Campaign Committees of Federal Candidates at the Same Rate of Tax Applicable to Committees of State and Local Candidates (the Highest Corporate Rate)

There is no apparent rationale for treating federal candidate campaign funds more favorably than those of state and local candidates, particularly with the often greater difficulty in raising funds for state and local campaigns. We believe that fairness and simplicity would support the same standard for both. Consistency could be achieved by the adoption of this proposal or by lowering the tax on state campaigns to the level applied to federal campaign committees.

A Proposal to Impose a 30% Excise Tax on Expenditures of Tax-Exempt Organizations for Lobbying (Including Amounts Paid as Salaries and an Allocable Portion of Support Costs)

The 1993 Budget Reconciliation Act has just addressed the issue of nondeductible lobbying expenses. Part of the rules applicable to this area require a tax-exempt organization either to notify its members of an allocable portion of dues which are nondeductible because of lobbying activities undertaken by the organization or, in the alternative, to pay a "proxy tax" at a 35 percent rate on the amount of expenditures allocated to lobbying.

It is not clear how this proposal fits into the context of the 1993 law. One would hope that there is not a serious suggestion to impose an additional 30 percent excise tax on top of the proxy tax or disallowance rules that now exist. To the extent that the proposal was initiated prior to the conclusion of Congressional debate on the 1993 Act, we would assume it now becomes moot.

A Proposal to Include Contacts with Regulatory Agencies (Except Local and Use Agencies) in the Definition of Lobbying for Purposes of the Existing Restrictions on Section 501(c)(3)

This proposal has the same faults as described for the previous issue, but it expands the problem to include administrative matters. Again, comments on proposed regulations and assistance to the government on various matters, such as the AICPA helping the IRS improve tax forms, should not be discouraged.

A Proposal to Deny Corporations a Deduction for All (or Part) of Interest Paid to the IRS on Tax Underpayment

Interest paid by corporations to the IRS on tax underpayments is an ordinary and necessary business expense and should be deductible. A departure from the concept that expenses incurred in the production of revenue are deductible in arriving at income is a shift from what is commonly understood to be an income tax base. Such a change runs against the tax policy of matching costs with revenues, and it should be rejected.

There is no tax policy reason for drawing a distinction between interest paid to the government and interest paid to other lenders. More underpayments are the unintentional result of complexity and uncertainty in the tax law than any effort to keep money from the government. Often the period for which interest is calculated is prolonged by slow IRS processing or honest disagreement as to the amount of tax due. Where a legitimate mistake is made in working with our complex tax law and the correct tax is not determined by the IRS for some time, denying the interest deduction seems particularly unfair. If the taxpayer is at fault, penalties may apply, and the overly broad sanction of denying interest deductions unfairly shifts an honest dispute into a penalty-type (i.e., nondeductible) environment.

Interest paid by taxpayers is already biased in favor of the government which pays one or two percent less on overpayments than taxpayers are required to pay on underpayments. To disallow deductions assessed at a higher level of interest and to require income inclusion of interest earned at a lower level compounds this unfairness. If taxpayers proposed that interest received from the government should be tax exempt, this would be immediately dismissed based on sound tax policy reasons as a raid on the Treasury. The logic is identical for dropping this proposal--only the revenue is different, and that is not a distinction based on sound tax policy.

A Proposal to Increase the Rate of Interest Payable on Corporate Tax Delinquencies

This proposal would compound the error of the prior proposal to deny a deduction for all or part of the interest paid to the IRS on tax underpayments. The tax burden on businesses is already substantial, and adding to it at this time does not encourage capital or jobs formation and works against an economic recovery.

A Proposal Based Upon a Provision in H.R. 5270, as Introduced in the 102nd Congress, to Modify the Method by Which Income From the Sale of Inventory is Sourced

In 1986, Congress considered and completely rejected any substantive changes to this area of the law since it had been in place and unchanged for more than 60 years; it did, however, order the Treasury Department to study the matter and report back. In response to section 1211(d) of the 1986 Act, ordering the Secretary to study the long range impact of the sale-source rules, Treasury issued an extensive report on January 15, 1993. The report makes no substantive recommendation, but states that study of the issue would be appropriate in the context of an overall review of our international tax system.

It would appear that after complete consideration of the matter in 1986, and a detailed study by the Treasury Department delivered in 1993, no further action could be warranted. Any loose interpretation that might have existed in sections 862 and 863 was firmly tightened by the Service in Rev. Rul. 88-73 and IRS Notice 89-10 (dealing with independent factory prices) and the various cases decided since 1986. The actual regulations have been in effect since the mid 1920's and are themselves heavily relied on by U.S. corporations in planning their international affairs. It is also clear that the sale-source rule encourages exports and allows U.S. companies to compete more effectively in international markets. Any further tinkering in this area is clearly unwarranted and would only add to the confusion that already pervades the international tax arena. If Congress were to replace the foreign tax credit with a deduction, then the sourcing rules would become irrelevant.

A Proposal to Require Written Substantiation of Any Meal or Entertainment Expense Claimed as a Business Deduction; Alternatively, a Proposal to Require Written Substantiation of Any Meal or Entertainment Expense in Excess of $10

The additional recordkeeping necessitated by this provision would be burdensome to businesses, and would not yield enough revenue to make it worthwhile. Section 274 delegates to the Secretary of the Treasury the authority to set a de minimis amount for recordkeeping, and if there were a compliance problem, this could be handled administratively. Absent such a problem, we believe that a small amount of revenue should not be exacted from generally complying taxpayers who have not had to meet more rigid recordkeeping requirements.

It should be noted that the $25 substantiation threshold currently in the law was enacted in 1962. In 31 years, that number has never been adjusted for inflation. The current proposal moves in exactly the wrong direction.

A Proposal to Limit the Deduction for Wagering Losses to 80% of the Amount Otherwise Deductible

As with a number of other positions taken in our testimony where expenses related to the production of income are limited or denied (such as those related to business use of a vehicle or business needs), we oppose limiting deduction for wagering losses. This arbitrary limit on deductions is unfair to taxpayers, who must include gambling winnings fully but would have to limit deductions of gambling losses. There is already a limit on gambling losses to the extent of winnings to prevent the government from subsidizing a taxpayer's wagering.

A Proposal to Amend the Like-Kind Exchange Rules to Require that the Code Section 1031 Property Received Must be "Similar or Related in Service or Use" to be Property Exchanged, Except in the Case of Condemnations

The change suggested will result in unneeded complication of well-settled law. The change will likely have a chilling effect on real estate transactions, a result inconsistent with the intent of the many changes (including the passive loss rules) in OBRA 1993 (PL 103-66). Taxpayers who are in the real estate business often invest in improved and unimproved property, which under present interpretations qualify as property of a like kind. However, improved and unimproved property would not qualify under the functional "similar or related in service or use" test. If the proposal is adopted, the real estate business would be more severely affected than other businesses, such as manufacturing, where assets already qualify under the functional use test.

The concept embodied in section 1031 is to not tax transactions where no cash in realized. The proposed change will stifle investment in property held for productive use or investment. Although the proposal would make the replacement property requirement the same as under section 1033, there is no simplification gained.

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Once again, we appreciate the opportunity to present our views here today and we stand ready to assist you in any way.

Mr. McNULTY. Thank you very much. I thank you all for your testimony. All of your statements will appear in the record in their entirety. I just have a couple of questions.

Mr. Dakin, as you know, in at least two recent cases the IRS has ruled that environmental remediation costs must be capitalized and apparently there is some question as to how the law may be applied in future cases. Now, I noted in your testimony that you do not suggest a legislative response to this issue, but I was just wondering in the meantime how are your members treating such costs?

Mr. DAKIN. I don't have access to the tax returns of the various NAM member companies.

Mr. McNULTY. Do you have some sense of what they're doing?

Mr. DAKIN. I do not know how they are treating it. I will say that there is case law that distinguishes between items which should be expensed for tax purposes and items that should be capitalized and I would imagine that companies are following that case law.

The two technical advice memoranda are well known, and NAM and other groups are having discussions on this and have had for the last year or so, so we are hopeful that the matter will be resolved administratively.

Mr. McNULTY. Thank you. Mr. Kalish, if you were here earlier, you know that we talked about this proposed repeal of section 530 at the beginning of the hearing. I note your strong opposition to the repeal.

I just wanted to ask about the many workers who perform services for the subcontractor and are misclassified as independent contractors, many times against their choice. This results in the loss of necessary benefits such as health benefits and Social Security coverage.

How would you respond to that?

Mr. KALISH. I am really not familiar with how the subcontractors treat their employees. As a builder, we hire a subcontractor and we pay him a negotiated amount and we submit to him at the end of the year a 1099, so I am not really sure how he treats his people. I would assume he treats his people as employees, but I really don't know.

Mr. McNULTY. Well, apparently there are some different opinions about that, so I think that we ought to pursue that a little bit further. I think that perhaps we can reach some kind of a middle ground on that topic.

Mr. KALISH. I am sure that I will speak to the staff of the National Association of Homebuilders and have them do some research and have them get back to the committee, sir.

Mr. McNULTY. Thank you.

[The following was subsequently received:]

During the testimony, Mr. McNulty inquired about the "many workers who perform services for the subcontractor and are misclassified as independent contractors . . . thus resulting in the loss of necessary benefits such as health benefits and social security coverage." Mr. Kalish indicated that NAHB staff would research the treatment by subcontractors of their workers.

As pointed out, the builder submits a form 1099 to the subcontractor and is usually unaware whether the subcontractor classifies its workers as employees or as independent contractors. The available research does not address this issue. We would welcome an opportunity to discuss this matter further in an attempt to develop a workable middle ground, as Mr. McNulty suggested.

Mr. McNulty. Ms. Gackenbach, I really don't have a question for you. You very clearly outlined your view with regard to this controversy about the proper tax treatment of environmental costs and we take note of that. If I understand you correctly, you don't suggest a legislative response to that?

Ms. Gackenbach. Not at this time we don't think it is warranted.

Mr. McNulty. Thank you. But I would like to ask that question of Ms. Pecarich because I wasn't quite clear whether you felt that way given the current uncertainty about the proper tax treatment of environmental cleanup costs.

Do you believe that this is an area where appropriate legislation could provide the simplification that we are looking for?

Ms. Pecarich. Our statement suggests that this whole area deserves further consideration and study. The AICPA works through the committee structure, so I don't have the full recommendations of the committee that considered this.

Mr. McNulty. So you haven't developed a policy, but you are not necessarily opposed to pursuing a simplification legislatively?

Ms. Pecarich. Not necessarily. I think the issue that you are faced with is much like the amortization of intangibles where there are a lot of disparate fact situations and not enough guidance and we are getting seriatim guidance out of the service that isn't totally satisfactory, and I think the question is: Do we wait for those matters to be resolved in the courts or is some other solution more appropriate?

Mr. McNulty. On behalf of Chairman Rangel, I want to thank all of you for your testimony. Thank you.

I would announce at this time that we will be taking a very brief recess for about 10 minutes, after which Congressman Neal will be here to chair the balance of the hearing. The committee hearing stands in recess until 12:10.

[Recess.]

Mr. Neal [presiding]. Thank you for allowing us that inconvenience. The second panel that will now be invited to submit testimony for the record is represented by Peter F. McCloskey, who is the president of Electronic Industries Association; Thomas G. Singley, who is the general manager of the Shell Oil Corporation and represents the Chemical Manufacturers Association; the North American Reinsurance Corp., Peter Gentile, who is the senior vice president and is accompanied by Kenneth Kies—Kies?

Mr. Kies. Kies.

Mr. Neal. Kies, OK. The National Association of Independent Insurers, represented by Robert Jarratt, who is the executive vice president and chief executive officer of the Florida Farm Bureau General Insurance Company; and the American Nuclear Insurers, Robert Rahn, counsel.

Mr. McCloskey.

STATEMENT OF PETER F. McCLOSKEY, PRESIDENT, ELECTRONIC INDUSTRIES ASSOCIATION

Mr. McCloskey. Good afternoon, Mr. Chairman. I am president of the Electronic Industries Association and I am pleased to present the views of the U.S. electronics industries on the proposal to change the foreign tax credit to a deduction and the proposal to change the source rule on the sale of inventory.

In addition, we are also pleased to offer additional comments for the record in our written statements on the denying of the corporate deduction for all or part of the interests paid to the IRS on tax underpayments, the rate of interest applicable to tax delinquencies, and the proposal to disallow deductions for compensatory damages incurred under the environmental laws.

I am particularly pleased in the administration's testimony earlier today that they did not support or oppose all of these proposals. In the interests of time, I will keep my comments brief.

EIA strongly opposes the proposal to change the foreign tax credit to a deduction. Chief among the reasons is that the proposal would abrogate longstanding U.S. policy directed toward avoiding double taxation of international income through the use of the foreign tax credit system.

Simply stated, the replacement of the foreign tax credit with a deduction would severely impact the competitiveness of U.S. companies operating abroad because it would subject them to economic double taxation. Under current law, the foreign tax credit ensures that the foreign income of U.S. companies is subject to the higher of either the foreign or the U.S. tax on such income, but not the sum of those two corporate income levels.

Our foreign competitors operating in the same overseas markets as U.S. firms do not have such a tax penalty placed on them. Rather, their home countries either provide for a home country tax exemption on such foreign income or provide a comparable foreign tax credit system as is currently available in the United States.

The impact of this proposal fails to take into account the reality of today's economy, namely that U.S. companies must compete in a global marketplace. Rather than slowing our ability to work in the international economy, EIA believes policymakers must make the United States the world's best place in which to manufacture and from which to export. The change in the foreign tax credit to a deduction harms our ability to accomplish this important goal.

The second one is the change in the export source rule. We are understand that that proposal is similar to the provision contained in H.R. 5270 in the last Congress and which would have modified the inventory income sourcing rule in two ways. First, income derived from products manufactured in the United States but sold outside the United States would be allocated by applying the production marketing split of current law to the combined income of the U.S. producer and any related foreign purchaser of the product. This is a change from current law which applies the production marketing split just to the income of the U.S. producer.

Second, the proposal would mandate a U.S. source for any income associated with the direct or indirect sale of inventory product for use, consumption, or disposition in the United States. Going back to that first provision, it would detrimentally affect the ability of U.S. companies to compete in the international marketplace by increasing their costs, thus requiring an increase in the current price of goods sold to non-U.S. customers.

Since non-U.S.-based competitors would not be forced into the same price increase action, they would naturally recognize the competitive advantage over our American counterparts. Several aspects of U.S. statutory and case law are designed to prevent such abuses including increased penalties under the section 482 transfer pricing rules which have just this year been legislated and the new section 482 regulations also released this year which provide detailed guidance on how cross-border transfer prices are to be established so as to reflect the best possible estimation of fair market value.

The second provision is objectionable from a practical standpoint in that it would require U.S. exporters to trace the use of their products by some three or more customers down the product sales line. This will create an additional paperwork burden for not only the U.S. company but for its customers as well; a most unwelcome condition of sales in the eyes of the customer.

As such, the proposal will increase the cost of exports from the United States to foreign customers providing another competitive advantage to foreign-based suppliers over U.S. companies. Consequently, it is our view that this is similar in its effect to the proposal to change the foreign tax credit to a deduction and correspondingly fails to address the market realities of the 1990s.

President Clinton stated the United States must ensure that its tax trade regulatory and procurement policies encourage private sector investment and innovation. These do not.

Thank you.

Mr. NEAL. Thank you very much, Mr. McCloskey.

[The prepared statement follows:]

ELECTRONIC INDUSTRIES ASSOCIATION

STATEMENT OF

PETER F. MCCLOSKEY
President

ELECTRONIC INDUSTRIES ASSOCIATION

Concerning Miscellaneous Revenue Provisions

Before The
Committee on Ways & Means
Subcommittee on Select Revenue Measures

Tuesday, September 21, 1993

I INTRODUCTION AND EXECUTIVE SUMMARY.

Good morning Mr. Chairman. My name is Peter McCloskey and I am President of the Electronic Industries Association. I am pleased to present the views of the U.S. electronics industry to the Subcommittee this morning on the proposals to change the foreign tax credit to a deduction and to change the source rule on the sale of inventory. In addition, we are also pleased to offer additional written comments for the record on (1) denial of corporate deduction for all or part of the interest paid to the IRS on tax underpayments, (2) the rate of interest applicable to tax delinquencies, and (3) the proposal to disallow deductions for compensatory damages incurred under environmental laws.

EIA is uniquely positioned to discuss the broad range of tax policy issues affecting our industry's international competitiveness. As the industry's oldest full service association, EIA is a vigorous trade organization with a close connection to a membership which represents the entire spectrum of the U.S. electronics industry. Our members comprise the most dynamic, growing, and forward-looking sector of the U.S. economy, and their operations offer significant insight into the future prospects for U.S. manufacturing competitiveness.

II CHANGE OF THE FOREIGN TAX CREDIT TO A DEDUCTION.

EIA opposes this proposal for a variety of reasons. Chief among them is the proposal's effective abrogation of long-standing U.S. policy directed toward avoiding double taxation of international income through the use of the foreign tax credit system. The law embodying this policy, reflected in the Internal Revenue Code's foreign tax credit provisions, has been in place since 1918.

EIA believes that this proposal would undermine the ability of U.S. companies to compete in the global marketplace by requiring U.S. firms to pay tax twice on every dollar of pre-tax profit earned in a foreign country. International competitors would not be subjected to such double taxation and would have, therefore, an immediate and substantial advantage over U.S. companies. Such an advantage could be parlayed into reduced price offerings to the customers, increased R&D or manufacturing plant additions; but the net result, in every case, would be a reduction in the U.S. share of the world marketplace.

Simply stated, the replacement of the foreign tax credit with a deduction would severely impact the competitiveness of U.S. companies operating abroad because it would subject them to economic double taxation. Under current law, the foreign tax credit insures that the foreign income of U.S. companies is subject to the higher of the foreign or U.S. tax on such income, but not the sum of those two corporate level income taxes. Our foreign competitors operating in the same overseas markets do not have such an onerous tax penalty placed on them as their home countries either provide for a home country tax exception on such foreign income or provide a comparable foreign tax credit system as is currently available in the United States.

We are also concerned that changing the foreign tax credit to a deduction would likely abrogate most U.S. income tax treaty obligations. Most treaties between the U.S. and other developed countries contain a prohibition against the double taxation of the income of residents of the treaty countries. Typically, the U.S. is obligated to allow a U.S. resident individual or company a credit against U.S. tax for income taxes paid in the other treaty country. This obligation is to be undertaken in accordance with the provisions of U.S. law as amended "without changing the general principle [of a foreign tax credit]..." 1989 Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, Art. 23 (1). (Other examples include Art. 23(2) of U.S./Italy Treaty, Art. 23(1) of the U.S./ France Treaty, Art. 24 (2) of the U.S./Spain Treaty, Art. 23(1) of the U.S./U.K. treaty, Art. 24(1) of the proposed U.S./Mexico Treaty, and Art. 25(4) of the proposed U.S./Netherlands Treaty.)

In addition, such a change would require an enormous revamping of the current income tax system. This would involve a great administrative expenditure on the part of both the government and the taxpayer at a time when both government and taxpayers are attempting to streamline their operations.

We caution that both the recent macro-level and individual product-level achievements of the U.S. high technology sector are by no means guaranteed and that the pressures associated with international competition will remain intense for the U.S. economy. The imposition of a large, new tax expense will most assuredly have an adverse affect upon this progress and will harm the President's plan to boost U.S. high-tech leadership in world markets.

III CHANGE IN THE EXPORT SOURCE RULE.

We understand that this proposal is similar to the provision contained in Section 203 of H.R. 5270 from the 102nd Congress which would have modified the inventory income sourcing rules in two ways. First, income derived from products manufactured in the U.S. -- but sold outside the U.S. -- would be allocated by applying the "production/marketing split" method of current law to the combined income of a U.S. producer and any related foreign purchaser of the product, (instead of just to the income of the producer as is the case under current law). Second, it would mandate a U.S. source for any income associated with the direct or indirect sale of inventory property for use, consumption, or disposition in the U.S.

The first provision would detrimentally affect the ability of U.S. companies to compete in the international marketplace by increasing their costs, thus requiring that the current price of goods sold to non-U.S. based customers be increased. Since non-U.S.-based competitors would not be forced into the same price-increase action, they would naturally recognize a competitive advantage over their American counterparts.

We dispute the arguments used in the past in support of this proposal which claim that the inventory source rules, as they currently exist, can be taken advantage of by U.S. exporters. In fact, several aspects of U.S. statutory and case law designed to prevent such abuses are already in place. For example, increased penalties under the Section 482 transfer pricing rules have just this year been legislated, and new Section 482 regulations (also just released this year) provide detailed guidance on how cross-border transfer prices are to be established so as to reflect the best possible estimation of fair market value.

The second provision is objectionable from a practical standpoint in that it would require U.S. exporters to trace the use of their products by up to three or more customers down the line. This will create an additional paper burden for not only the U.S. company but for its customers as well, an unwelcome condition of sale to the customer. The proposal will also obviously increase the cost of exports from the U.S. to foreign customers, providing a competitive advantage to foreign-based suppliers over U.S. companies. Perhaps less obvious, however, is the overall sales disadvantage associated with the paperwork burden required of the customer under the provision. In today's highly competitive global market, cost is assessed by customers through a variety of means, including the cash price of the product or service, and a number of "soft" costs. This provision would raise the "soft" cost expense of U.S. products by prompting customers to invest scarce staff time and administrative resources into complying with U.S. supplier requirements occasioned by this provision. In short, Mr. Chairman, we live in a world where customers ask not only "how much?" but also "how long does this take?" and "how many people are required?". This provision fails to understand this key market reality.

Finally, we reiterate our continued support of our industry's joint testimony on this subject from the July 21, 1992 full committee hearing on H.R. 5270:

> "The export source rule is one of the few GATT-legal provisions in the tax code that operates as an export incentive. No one should question the significant role our exports have played in our economy. Our exports have continued to create and sustain significant U.S. jobs. Many of these jobs are high paying manufacturing jobs."
>
> "The export source rule, while it did not start out as an incentive, has since 1986 become a powerful export incentive. Many foreign tax provisions were cut back and amended to retain this powerful incentive in the 1986 Act. We strongly urge you to reject this temptation to shoot U.S. exporting companies in the foot. Keep this incentive and we'll keep fighting for an export-led improvement to our economy." [at 18-19].

IV DENIAL OF THE CORPORATION DEDUCTION FOR INTEREST PAID ON TAX UNDERPAYMENTS.

Again, our comments mirror concern voiced in prior Congresses over similar proposals. As many in industry noted in their opposition to a comparable proposal considered and dropped from the Omnibus Budget Reconciliation Act of 1990, Congress should reject this proposal on the grounds that it erodes the fundamental right of a taxpayer to contest an honest tax dispute with the government before paying the amount of tax assessed. Changing this policy effectively denies taxpayers the ability to exercise these rights. Tax deficiencies result from uncertainty over the tax law and the application of the law to particular facts. They are typically not the result of improper behavior by taxpayers. The proposal would change the dynamics of tax protests and result in a one-way street in favor of the government by disallowing the deduction for deficiency interest owed to the government while imposing a tax on any refund interest received from the government.

Perhaps the best way to underscore our concern is through an example showing the inequity of the rule's effect in instances connected with timing or "rollover" issues where income items or deductions are simply moved from one year to another. Under the proposal and in such circumstances, the interest due the government in the deficiency year would be nondeductible, whereas the interest due the taxpayer in the refund year would be fully taxable:

EXAMPLE. A $28.6 million deduction taken in Year 1 is deferred, per IRS audit, to Year 2. This creates a $10 million tax deficiency in Year 1 and a $10 million tax refund in the same amount in Year 2. The tax treatment of the resulting interest on the deficiency and refund is as follows:

	Year 1	Year 2	Total
Interest Expense	$(700K)		
Interest Income		$600K	
PBT	$(700K)	$600K	$(100K)
Tax Benefit	-0-		
Tax Cost		$(210K)	
Total		$(210K)	$(210K)
PAT	$(700K)	$ 390K	$(310K)

EXPLANATION: The $310K net detriment is attributable to the $210K tax imposed on the $600K interest refund in Year 2 plus the $100K of additional non-deductible deficiency interest in Year 1 because of the 1% differential between the rates of deficiency interest and refund interest. (This example assumes a 35% corporate tax rate, a 7% deficiency interest rate and a 6% refund interest rate, and that the interest runs for only one year in each case.)

V THE RATE OF INTEREST APPLICABLE TO TAX DELINQUENCIES.

This proposal, too, mirrors a proposal raised in a prior Congress. And like its predecessor, this proposal should also be rejected. There is already a difference in favor of the government in the rate of interest the government pays taxpayers on tax refunds versus the amount of interest taxpayers pay on delinquencies. It is EIA's view that interest should be applied equally, whether a taxpayer is due a refund or is required to pay a delinquency. We agree with the February 28, 1992 letter signed by six former assistant Treasury secretaries for tax policy to former assistant secretary for tax policy Fred Goldberg, which, in commenting on a similar proposal in the last Congress, termed it "manifestly unfair on its face." See Daily Tax Report (BNA), No. 41, G-5 (March 2, 1992). We note that the similar 1992 proposal was rebuffed even though it was ostensibly "justifiable" on the strength of its badly-needed revenue-raising capabilities. The 1993 proposal cannot be similarly justified and, as such, should also be rejected.

VI DISALLOWANCE OF DEDUCTION FOR COMPENSATORY DAMAGES INCURRED UNDER ENVIRONMENTAL LAWS.

Unfortunately, given the lack of detail on this proposal, it is difficult to provide specific industry reaction. Nonetheless, as a broad policy statement, the tax treatment of all environmental remediation costs should be guided by the "matching principle". Under this principle, environmental costs would be currently deductible because they relate to past income-producing activities and not to the production of future income. Consequently, most remediation costs would meet the definition of "ordinary and necessary" business expenses under Section 162 of the Internal Revenue Code and would be, therefore, currently deductible. Clarification of the recent INDOPCO decision may be warranted, to prevent its limited holding from being overextended in the environmental area. In this respect, careful consideration must be given to whether any tax legislation will have the effect of incentivizing or disincentivizing individuals and businesses to engage in environmental cleanup efforts.

VII CONCLUSION.

President Clinton has stated that "the United States must * * * ensure that its tax, trade, regulatory, and procurement policies encourage private sector investment and innovation. In a global [economy] where capital and technology are increasingly mobile, the United States must make sure that it has the best environment for private sector investment and job creation." Technology for America's Growth, supra, at 12.

The proposals we comment on today would frustrate these important goals by increasing the costs of U.S. business operations in international and domestic markets. They have no apparent overriding tax or economic policy justification, and will likely lead to an export of U.S. manufacturing, R&D activities and jobs. These are not the items we want to export. Rather, we want to continue to export the best products and services that our people and our technology can produce. We therefore strongly urge that these proposals be rejected.

Mr. NEAL. We will now have an opportunity to hear from Mr. Singley.

STATEMENT OF THOMAS G. SINGLEY, GENERAL MANAGER, TAX DEPARTMENT, SHELL OIL COMPANY, HOUSTON, TEX., ON BEHALF OF THE CHEMICAL MANUFACTURERS ASSOCIATION

Mr. SINGLEY. Thank you, Mr. Chairman. I am Thomas G. Singley, a general manager of Shell's Tax Department appearing on behalf of the Chemical Manufacturers Association. I request that our written statement be included in the hearing record and will summarize my remarks.

CMA is a nonprofit trade association. Our member companies represent more than 90 percent of the productive capacity of the basic industrial chemicals in the United States. In 1992, the U.S. chemical industry was the Nation's leading exporter and now provides 1.1 million high-wage, high-tech jobs for American workers.

I will restrict my oral comments today to only five proposals before the subcommittee. First, we oppose the proposal for the capitalization of environmental remediation expenses. Second, we believe eliminating foreign tax credit is a bad idea and so are any proposals that would change the inventor export source rules.

Next, we believe there is no justification for adding new chemicals at this time to the existing CFC tax. And last but certainly not least, we believe an oil import fee would be disastrous not only to our industry but to all U.S. industries.

I will say a few specifics about each one of these. First, we strongly oppose proposals to capitalize environmental remediation costs. Environmental remediation costs to meet stringent Federal and State requirements are expensive, technically difficult, and complex. Providing more severe tax treatment for these costs than for other business expenses is a bad idea, it seems to us, at a time when so many Federal and State legislative and regulatory policies have been aimed at encouraging and mandating these sort of activities also. We urge you to reject the proposals to capitalize these expenses.

Second, we oppose eliminating foreign tax credit. Allowing only deduction for foreign taxes would create yet another serious impediment to the ability of U.S.-based manufacturers to compete globally and we are happy to see the Treasury Department agrees.

As you have heard earlier today, instead of piecemeal efforts, we think Congress should undertake a comprehensive reform of the tax treatment of foreign income of which the foreign tax credit is an important part.

Next, the proposed changes to the inventory source—export source rule would severely reduce incentives to export U.S. products by greatly increasing a portion of such income as treated as U.S.-sourced. At the same time, the rule would increase complexity and costs for U.S. manufacturers.

Since, as I mentioned, the chemical industry is a leading U.S. exporter, we strongly oppose changing the current inventory source rules in this way and, again we are happy to see Treasury agrees with this position.

Next, CMA objects to adding new chemicals to the list of those taxed under the ozone depleting chemicals excise tax. One stated objective of this tax was to provide an incentive for producers and users of CFCs to accelerate the transition to HFCs, most of which have about one-tenth the ozone depleting potential of these CFCs. Taxing HCFCs now would penalize the investment in the alternative technology before safe and effective substitutes are available for many applications and uses.

Finally, we oppose fees on imported crude oil and refined petroleum products. Energy intensive energies like the chemical industry would be especially hard hit by an oil import fee.

We estimate this fee would increase U.S. chemical, energy, and feedstock costs by about a half a billion dollars each year. Our experience with these taxes—and the Superfund excise taxes are a good example—show that fees of this type tend to subsidize imports of untaxed downstream products. They also penalize U.S. exports and they add to the Nation's already large trade deficit.

Thank you, Mr. Chairman, that concludes my statement.

Mr. NEAL. Thank you very much, Mr. Singley.

[The prepared statement follows:]

BEFORE THE HOUSE WAYS AND MEANS
SUBCOMMITTEE ON SELECT REVENUES

STATEMENT OF

CHEMICAL MANUFACTURERS ASSOCIATION

ON

MISCELLANEOUS REVENUE-RAISING PROPOSALS

The Chemical Manufacturers Association ("CMA") appreciates this opportunity to address the Subcommittee on Select Revenues on the miscellaneous revenue-raising proposals submitted by committee members as measures to offset the revenue cost of other tax proposals.

CMA is a non-profit trade association. Our member companies represent more than 90 percent of the productive capacity for basic industrial chemicals in the United States. The U.S. chemical industry provides 1.1 million high-wage, high-tech jobs for American workers.

CMA is most concerned that the subcommittee has chosen to hold these hearings so soon after Congress enacted comprehensive budget legislation that mandates tax increases of more than $250 billion over the next five years. Moreover, the subcommittee will review several proposals that have widespread application and that are vital to our nation's economy and to the chemical industry.

These subjects include, among others, the income tax treatment of environmental remediation costs and settlements, changing the foreign tax credit to a deduction, sourcing income from the sale of inventory property, and adding new chemicals to the list of taxable ozone-depleting chemicals. Moreover, in the first month after the Congressional debate on energy taxes, the subcommittee will consider yet another proposal to tax energy by increasing the tariff on imported crude oil by 15-cents per barrel and on refined petroleum products by 1-cent per gallon.

CMA respectfully submits that it is inappropriate to take up these proposals simply as revenue sources to pay for other tax amendments. Moreover, these proposals would seriously harm the U.S. chemical industry and the nation's economy, and impede a jobs-producing recovery.

Mr. Chairman, we recognize that the limitations created by the Congressional budget process greatly strain the ability of the Committee on Ways and Means and the Congress to manage ongoing problems that arise in a complex economy under the Federal tax system. Indeed, those budget rules make it difficult, if not impossible, to correct any serious tax problem that would reduce Federal tax revenues. However, CMA submits that proposals to modify major aspects of the Federal tax system should only be considered in the context of the serious economic problems to which they apply and not as a source of off-setting revenues for other tax changes.

U.S. tax changes must not be viewed in isolation. Raising U.S. income taxes only increases the tax burden of U.S. exports in world markets and the corresponding tax advantage of imported products in the United States. CMA has testified on several occasions that the budget problems of the Federal Government may require an alternative tax reform like the invoice credit value-added tax to replace portions of the present tax system. Such a reform could increase overall revenues and enhance the international competitiveness of U.S.-based manufacturers and the American jobs they provide.

In the meantime, CMA urges the Committee on Ways and Means to seek amendment of controlling budget rules to permit the committee, subject to some overall budgetary limitation, to correct serious tax problems without regard to baseline revenue projections. For many years this committee operated under procedures that permitted it to act on these limited revenue amendments. Under those procedures, the committee would report such amendments if there were no objection from members of the committee, the Treasury Department, and the technical staffs of the committee. The reported bill could then be considered on the House floor under the suspension or unanimous consent calendars. CMA believes that these procedures are equally justified today.

In addition, CMA opposes using the select revenue amendment process to consider the following proposals:

1. **Capitalizing Environmental Remediation Costs:**

CMA strongly opposes proposals to modify the tax treatment of environmental remediation costs by specifying the types of such costs that must be capitalized, or, alternatively, by requiring that all such costs be amortized over a uniform period of years. Mr. Chairman, we believe that these proposals raise many questions of vital national concern.

For many years, section 162 of the Internal Revenue Code has provided that taxpayers may deduct for income tax purposes all ordinary and necessary business expenses. Special rules apply to disallow payments of fines, penalties and treble damage payments in the nature of penalties. Under this general rule the cost of cleaning up a hazardous substance discharge is a deductible business expense. Thus, current Federal tax law does not penalize expenditures for prompt and immediate action to cleanup any discharge of hazardous substances, to confine and, if possible, to mitigate any environmental or property damage arising from the discharge, and to make restitution to those injured or damaged.

Environmental remediation activities to meet stringent Federal and state requirements are expensive, technically difficult, and procedurally complex. Providing more severe tax treatment for these expenses would seriously impair the ability of U.S.- based manufacturers to compete both in domestic and world markets.

Allowing the current deduction of these expenses does not create a tax shelter. It simply recognizes that environmental cleanup and remediation costs are additional expenses that reduce net income. The U.S. chemical industry's long term practice has been to encourage prompt, private response to any discharge or spill of hazardous substances. For many years, the industry has funded a number of private programs to minimize the damage and loss attributable to these events. Yet, over the years, the chemical industry has consistently been one of America's highest taxed industries.

CMA has commissioned several studies by Price Waterhouse in recent years to determine the effective tax rate of the chemical industry under the methodology the Joint Committee on Taxation employed in the "Pease-Dorgan" studies. In the most recent of these studies Price Waterhouse concluded the effective U.S. tax rate of the industry in 1989 was 34.6 percent. It should be noted that this rate is near the statutory maximum corporate tax rate and was paid despite the fact that environmental remediation costs are deductible as ordinary and necessary business expenses under section 162.

The deductibility of environmental cleanup and remediation expenses as ordinary and necessary business expenses is driven by enormously complicated and involved fact patterns. The legal, tax, accounting, insurance, scientific and technical aspects of environmental remediation expenses are myriad. The Internal Revenue Service is conducting a study of these issues that will fundamentally affect both the environmental policies and revenues of the Federal government, as well as those of state and local governments. CMA strongly believes that the only responsible policy on on this subject is to encourage the prompt and responsible environmental cleanup and remediation efforts through current deduction of these expenses.

The resources of government and industry should be directed at minimizing situations that will require environmental cleanup and remediation. When situations do occur, they should be focused on doing the job as quickly and effectively as possible. We should not expend limited government and business resources to administer penalties and blame through the tax law. Ample statutory authority and administrative means already exist to achieve those purposes.

The chemical industry is proud of its environmental record, including the promotion of safe transportation of hazardous materials. On an annual basis, over 99 percent of all chemical shipments arrive without incident and the majority of the incidents that do occur are minor in nature.

We are also proud of the private programs that we have undertaken in the public interest to minimize the consequences of incidents involving hazardous substances. A critical element of any hazardous materials response is the availability of timely and accurate information and expertise on how to deal properly with the release. For 22 years CMA's Chemical Transportation Emergency Center (CHEMTREC®) has provided specific product information to regional, state, and local emergency response teams throughout the United States and Canada.

Moreover, CMA and its member companies actively maintain a leadership role in providing training and assistance to emergency response teams. Over the last eight years almost three quarters of a million emergency responders have taken advantage of CMA's library of training materials. In addition, the chemical industry has provided valuable public service through its Responsible Care® initiative, hands-on emergency response training programs, and numerous other industry programs to address public and industry concerns. CMA is continuing to expand and to improve these programs to meet current and future needs.

This system of private initiative and response to minimize and to confine the effects of hazardous materials emergencies has demonstrated its great importance and public value. CMA urges the Subcommittee on Select Revenues, therefore, to reject proposals to capitalize or to amortize environmental cleanup and remediation costs. Most importantly, we urge that the serious questions of environmental policy and of the international competitiveness of U.S.-based manufacturing that these proposals would raise deserve comprehensive hearings by the full committee.

2. **Foreign Tax Proposals**:

Changing Sourcing Rules for Inventory Sales

Last year, H.R. 5270 proposed changes to the rule for determining the source of income a U.S. corporation derives from exporting inventory property through a related party. Currently, U.S. manufacturers can, in certain cases, use a formula that generally permits the manufacturer to treat 50 percent of the taxable income from an export sale as U.S. source production income, and 50 percent as foreign source sales income. The proposal would have altered the formula to the considerable disadvantage of both U.S. exporters and the U.S. economy.

Numerous taxpayers expressed their strong opposition to the change. Among their many legitimate concerns was the fact that the proposal would have resulted in increased complexity and costs for U.S. manufacturers while at the same time severely reducing their incentives to export products produced in the U.S.

CMA wholeheartedly agrees with those concerns and wishes to take this opportunity to express our strong opposition to any change to the inventory sourcing rules based upon the proposal in H.R. 5270.

Eliminating the Foreign Tax Credit

Since 1918, U.S. taxpayers have been allowed a credit against U.S. tax for foreign taxes paid. The credit is designed, generally, to avoid double taxation of foreign income which has been taxed by a foreign country.

CMA strongly opposes the proposal to eliminate the foreign tax credit. Allowing only a deduction for foreign taxes would create yet another serious impediment to the ability of U.S. multinationals to compete effectively in our increasingly global business environment by causing significant double taxation. Indeed, the substantial increased tax burden on U.S. taxpayers caused by this ill-advised proposal will surely be welcome news to their foreign competitors.

The proposal fails miserably to promote any rational international tax policy objective. It is anti-competitive at a time when U.S.-based manufacturers are beginning to compete more effectively with foreign-based manufacturers. Adopting the proposal, therefore, would not only seriously inhibit the ability of U.S.-based manufacturers to expand into new markets but also would threaten their current market positions.

CMA strongly objects to the proposal and urges that it be rejected. Congress should instead address existing deficiencies in the foreign tax credit system in order to promote and improve the international competitiveness of U.S.-based manufacturing in the global marketplace, such as the unjustified limitation on the credit faced by companies paying the alternative minimum tax.

New Five Percent Excise Tax on Purchases by Foreign Corporations

We have not had the opportunity to study this proposed legislation and, thus, do not know the instances in which it would apply. CMA would, however, point out that severe penalties already apply when a foreign corporation or foreign-controlled U.S. corporation fails to provide information the Internal Revenue Service requests in connection with an audit.

Withholding Tax on Certain Portfolio Interest

A 30 percent withholding tax is imposed on certain U.S. Source interest income received by foreign persons. However, in 1984 Congress exempted "portfolio interest" from U.S. tax. In enacting the exemption, Congress recognized that the withholding tax impaired the ability of U.S. corporations to access international capital markets which greatly increased their borrowing costs. The exemption allows U.S. borrowers to borrow more efficiently and, thus, at lower interest rates.

Reinstating the withholding tax on portfolio interest would increase interest rates for all U.S. borrowers, including the United States Government. This result was most recently demonstrated by the dramatic upswing in the interest rate on the 30-year U.S. Treasury bonds caused in part by the mere possibility that the withholding tax would be reinstated.

CMA believes the repeal of the portfolio interest exemption is unwarranted. It would almost inevitably lead to an immediate escalation in U.S. interest rates, a result that our recovering economy cannot tolerate.

3. Additions to List of Taxable Ozone-Depleting Chemicals:

An additional revenue raising proposal would add methyl bromide, hydrochlorofluorocarbons (HCFCs), and hydrobromofluorocarbons (HBFCs) to the list of ozone-depleting chemicals (ODCs) that are taxed under Section 4682 of the Internal Revenue Code. Over the past decade, CMA has actively supported effective and efficient national programs to improve the environment. When Congress reviews tax proposals to improve the environment, it is important to evaluate their objectives in the light of national revenue, trade, and competitiveness policies.

In this regard, CMA opposes product specific taxes, including this new proposal to expand the base of the ODC excise tax. Industry and product specific taxes aimed at addressing environmental issues disproportionately impact narrow sectors of the economy without a guarantee of achieving their environmental objective. Thus, the tax could inflict serious harm on an industry with no offsetting societal benefits. If new revenues must be raised, CMA maintains that those revenues should be raised from as broad a tax base as possible, to distribute the tax burden fairly and equitably and not to impose a disproportionate impact on any single industry.

This certainly would be the case with respect to the users and producers of HCFCs. The proposed tax would not change behavior, instead would be an additional penalty imposed on the industry. As you will recall, when the ODC excise tax was first enacted, its stated objective in addition to raising revenue was to provide an incentive for producers and users to accelerate the transition to using HCFCs. Most HCFCs have about one tenth the ozone-depleting potential of CFCs.

Moreover, the Montreal Protocol and later the Clean Air Act had provided for phasing out the manufacture and use of CFCs. Nevertheless, industry invested hundreds of millions in research and equipment after enactment of the tax on CFCs to make this responsible transition to HCFCs. Although the transition is still underway, HCFCs are not fully available for every application today. Taxing HCFCs now would penalize those who have made substantial investments in this alternative technology before safe and effective substitutes are available for many applications and uses.

Industry- specific and product-specific taxes put U.S. producers and workers at a competitive disadvantage with their foreign counterparts. Specifically, new environmental taxes deplete industry funds precisely when they are needed most to meet mandated environmental standards. In the case of this specific proposal, the new taxes would further burden industries already spending large sums of money to invest in new equipment to transition away from CFCs and would direct resources they would otherwise use to develop better alternatives.

While CMA clearly opposes adding new chemicals to the existing tax base, if additional chemicals are added, we advocate that the same tax structure be maintained for the newly added taxable products. In 1989, when the ODC tax was enacted, Congress included provisions to tax imported products and provide a rebate for exported products. Chemicals that are recycled are not subject to additional taxes, and feedstock uses of chemicals are not taxable. Additionally, the tax due is based on the ozone-depleting potential (ODP) of the chemicals, recognizing that chemicals that have lower ODP should be assessed a smaller penalty. Finally, Congress granted special treatment to products used in the manufacture of rigid foam insulation, recognizing the important energy-conservation uses of rigid foam.

Finally, CMA supports the goals of legislation to improve and to protect our environment. We believe that the U.S. should continue to be the leader in the world-wide effort for a better, safer environment. Our nation's ability to pay for an improved environment, however, is dependent on maintaining the competitiveness of U.S.-based manufacturing. Tax policies that create additional disadvantages for U.S.-based production that must compete with foreign production will increase the overall cost to the U.S. economy of meeting national environmental goals.

4. Increasing Tariffs/Taxes/Fees on Imported Oil:

CMA strongly opposes the proposal to tax energy by increasing the tariff on imported crude oil by 15-cents per barrel and on refined petroleum products by 1-cent per gallon. Viewed as a tariff or tax, an oil import fee raises the cost of U.S.-based production relative to that of foreign-based production and would damage the international competitiveness of U.S. manufacturing.

Energy-intensive manufacturing industries-- like the chemical industry --would be especially hard hit by any broad-based energy tax like an oil import fee. An exemption from any such tax for chemical raw materials (feedstocks) would lessen the tax's severe adverse impact on U.S. international competitiveness, but would not eliminate its adverse impact. An oil import fee would have additional harmful consequences because the fee would also push the price of domestic oil and other energy resources up by an equivalent amount.

In 1992, the U.S. chemical industry consumed 17.9 million barrels (49,000 barrels per day) of fuel oil and other oil products for it heat, power, and electricity generation needs and 491.4 million barrels (1.346 million barrels per day) of liquefied refinery gases and heavy liquids for its feedstock needs. The higher oil product prices that would arise directly from the oil import fee would add about $215 million in annual energy and feedstock costs to the U.S. chemical industry. These higher oil products prices would also increase the prices paid for other energy sources by an additional $205 million. Thus, the proposed oil import fee would increase annual chemical industry energy and feedstock costs by about $420 million.

Under the General Agreement on Tariffs and Trade (GATT) and the U.S.-Canada Free Trade Agreement there is no practical means to neutralize the harmful effects of an oil import tariff or fee on the international competitiveness of U.S.-based production by imposing comparable levies on U.S. imports of finished goods. In effect, an oil import tariff or fee will subsidize imports, penalize exports, and add to our already large U.S. trade deficit.

For the first eight months of this year, Congress reviewed the proposed Btu tax and several alternative energy tax proposals. It seems most inappropriate for the Committee to revisit this subject so soon after the enactment of the Omnibus Budget Reconciliation Act of 1993.

CONCLUSION:

One major goal of the legislative process should be to maintain the international competitiveness of U.S.-based enterprises in our tax system. The issues that we have addressed suggest that present procedures that permit the review of amendments to benefit some taxpayers at the expense of others can threaten that competitiveness. Those procedures certainly do not help our nation's economy as a whole. Paying for such amendments with new or increased taxes on others is both inequitable and unacceptable. CMA, therefore, respectfully urges that the Committee on Ways and Means seek to amend Congressional budget rules to permit the enactment of limited tax amendments on their own merits and without regard to their impact on baseline revenues.

September 20, 1993

Mr. NEAL. We will now hear from Mr. Gentile.

STATEMENT OF PETER A. GENTILE, SENIOR VICE PRESIDENT, NORTH AMERICAN REINSURANCE CORP., NEW YORK, N.Y., ACCOMPANIED BY KENNETH KIES, COUNSEL

Mr. GENTILE. Thank you. Mr. Chairman, members of the Select Revenue Subcommittee, I am Peter Gentile, senior vice president of North American Reinsurance Corp., a corporation located in New York. North American Reinsurance's sole stockholder is SwissRe Holding, North America, Inc., a wholly-owned subsidiary of the Swiss Reinsurance Company headquartered in Zurich, Switzerland.

North American Reinsurance with its U.S. affiliates is the fourth largest reinsurer with approximately $700 million of capital and surplus. I welcome this opportunity to appear before this subcommittee today to discuss the proposal to increase from 1 percent to 4 percent the excise tax imposed on certain premiums paid to foreign persons for reinsurance covering property and casualty insurance.

This proposal is based on a proposal of H.R. 5270, which was introduced into Congress last year. Supporters of the proposal have claimed that a rate increase is necessary because U.S. reinsurers are at a competitive disadvantage with respect to foreign reinsurers.

North American Reinsurance from its perspective as a company that both reinsures and purchases reinsurance and from its perspective as a member of a coalition including over 1,000 insurance writers located throughout the United States opposes the proposal to raise the insurance excise tax.

An excise tax increase would make reinsurance more expensive to obtain and would restrict the reinsurance capacity available to U.S. insurers. An excise tax increase like that proposed in H.R. 5270 would be difficult to administer fairly and effectively. Furthermore, it would be inconsistent with obligations under many of our tax treaties, in particular the United States-United Kingdom tax treaty.

There is more demand by U.S. insurers for catastrophe reinsurance than U.S. companies are currently able to satisfy. A rate increase on reinsurance provided by foreign companies would result in either harmful coverage gaps or increased costs for reinsurance, both of which would be detrimental to U.S. consumers.

Because of recent catastrophic losses, U.S. insurers are facing a period of restricted capacity in the reinsurance market. Any tax increase would make this capacity problem worse. Access by U.S. insurers to foreign reinsurers increases the capacity for insuring U.S. risk. Because particular types of coverages are either unavailable or scarcely available from U.S. reinsurance companies, foreign reinsurers provide coverage that otherwise simply could not be obtained. For example, foreign companies are acting as a primary source of reinsurance for medical malpractice, earthquake, and hurricane, aviation, marine, nuclear, and aerospace coverage.

Even in the global marketplace, U.S. insurers currently are experiencing difficulty in placing reinsurance. This is due to the recent high level of losses incurred by the industry. We are all aware of the disasters, both natural and manmade, that all areas of our country are currently experiencing.

The magnitude of the 1992 catastrophes was staggering and contributed to the reporting of a record $34 billion in insurance industry underwriting losses that year. With the devastating floods this summer in the Midwest, the March blizzard, the World Trade Center explosion, and most recently, Hurricane Emily, 1993 is also developing into a costly year for the insurance industry.

The existing 1 percent excise tax on reinsurance should not be increased for the following additional reasons. As the 1990 Treasury report on this issue concluded, U.S. reinsurers are not operating under a competitive disadvantage even when the existing 1 percent tax on reinsurance premiums is waived by tax treaty. The Treasury report based its conclusion on its independent analysis of the impact of a simplified reinsurance transaction with companies located in several different countries.

In addition, many of our trading partners have made known their disagreement with past proposals to increase the insurance excise tax. These trading partners view current and post proposals as tantamount to tariff increases and they would consider taking steps to retaliate. Even countries with tax treaties with the United States which contain the excise tax waiver view these proposals as unilaterally changing their tax treaties. Retaliatory measures by our trading partners would have a harmful effect on the overall U.S. economy and would greatly damage international investment and trade of U.S. companies.

Finally, enactment of an excise tax increase is inconsistent with the spirit if not the specific provisions of the NAFTA agreement. For the above reasons, with a particular emphasis for its impact on U.S. consumers, I urge the committee to maintain the existing provisions of the excise tax on premiums.

Thank you, and I will be available to answer any questions that you may have.

Mr. NEAL. Thank you very much, Mr. Gentile.

[The prepared statement follows:]

STATEMENT OF THE
NORTH AMERICAN REINSURANCE CORPORATION
CONCERNING THE PROPOSAL TO
INCREASE THE FEDERAL EXCISE TAX ON
INSURANCE

I. Introduction.

I am Peter Gentile, Senior Vice President of the North American Reinsurance Corporation ("North American Reinsurance"), a corporation located in New York. North American Reinsurance's sole stockholder is SwissRe Holding (North America), Inc., a wholly owned subsidiary of the Swiss Reinsurance Company headquartered and incorporated in Switzerland. North American Reinsurance, with its U.S. affiliates, is the fourth largest reinsurance company located in the United States with approximately $700 million of capital and surplus. I welcome this opportunity to appear before the Subcommittee today to discuss the proposal to increase, from one percent to four percent, the excise tax imposed on certain premiums paid to foreign persons for reinsurance covering property and casualty insurance and bonds.

That proposal is based on a provision of H.R. 5270, the Foreign Income Tax Rationalization and Simplification Act of 1992, legislation introduced in the last Congress which many of our country's trading partners found most controversial. Supporters of the proposal have claimed that a rate increase is necessary because U.S. reinsurers are at a competitive disadvantage with respect to foreign reinsurers. North American Reinsurance, from its perspective as a company that both reinsures and purchases reinsurance, and from its perspective as a member of a coalition including over one thousand insurance writers located throughout the United States, opposes the proposal to raise the insurance excise tax.* An excise tax increase would make reinsurance more expensive to obtain, and would constrict rather than expand the reinsurance capacity available to U.S. insurers. An excise tax increase like that proposed in H.R. 5270 would be difficult to administer fairly and effectively. Furthermore, it would be inconsistent with obligations under at least the U.S.-United Kingdom tax treaty and possibly other treaties.

There is more demand by U.S. insurers for reinsurance than U.S. companies are able to satisfy. A rate increase on reinsurance provided by foreign companies would result in either harmful coverage gaps, or increased costs for reinsurance, both of which would be detrimental to U.S. consumers. Moreover, implementation of the proposal as detailed in H.R. 5270 could cause retaliation against U.S. companies by our trading partners.

Because of recent catastrophic losses, U.S. insurers are facing a period of restricted capacity in the reinsurance market. An excise tax rate rise would exacerbate that capacity problem.

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* North American Reinsurance is also participating with a coalition of trade associations opposed to the excise tax increase. This coalition includes the following: American Council of Education, American Insurance Association, Alliance American Insurers, Coalition of Independent Casualty Companies of America, National Association of Mutual Insurance Companies, National Association of Independent Insurers, American Nuclear Insurers, American International Group, American Association of Crop Insurers, National Association of Insurance Brokers; MAERP Reinsurance Association, American Agricultural Insurance Company, Physicians Insurers Association of America, Crop Insurance Research Bureau, Inc., Risk Insurance Management Society, and American Farm Bureau Federation.

II. The Current Insurance Excise Tax on Reinsurance.

When a foreign insurer or reinsurer is not subject to U.S. income tax, the U.S. imposes an excise tax on each policy of insurance, indemnity bond, annuity contract, or policy of reinsurance issued by the foreign insurer or reinsurer to, or for, or in the name of, a U.S. person with respect to risks wholly or partly within the United States, or with respect to any foreign person engaged in business within the United States with respect to risks within the United States.

The excise tax rate is currently 4 percent of premiums paid on policies of casualty insurance and indemnity bonds; 1 percent of premiums paid for life, sickness or accident insurance policies; and 1 percent of premiums paid on policies of reinsurance covering casualty or life insurance risks.

The excise tax is computed on the basis of gross premiums paid to the foreign insurer or reinsurer. Thus, the excise tax applies to premiums paid without any reduction for losses and expenses incurred by the insured or the insurer. Imposition of the excise tax is not dependent on the profitability of the foreign insurer or reinsurer. Thus, even if a foreign reinsurer realizes a loss on a particular reinsurance transaction, a tax is imposed if the risk is U.S. based. In light of current market conditions, this is precisely the situation facing many foreign reinsurers.

The excise tax is waived in certain cases under certain U.S. income tax treaties.

III. The Specifics of the Excise Tax Proposal of H.R. 5270.

Section 303 of H.R. 5270 proposed an increase in the excise tax on reinsurance premiums paid to foreign insurers, from the current 1 percent to 4 percent. However, reinsurance premiums would remain subject to only the existing 1 percent rate, if: (1) premiums and other insurance income related to the policy of reinsurance were subject to tax by a foreign country at an effective rate that was substantial, and (2) the insured risk was not reinsured by a resident of another foreign country who was not subject to a substantial tax, i.e., the premium was retained in a high tax country. Any person liable for the insurance excise tax would bear the burden of proving that the foreign taxes on insurance income were imposed at an effective rate that was substantial. This provision clearly would be difficult to administer due to the ambiguous nature of the statutory standard.

Section 303 of H.R. 5270 also provided that, in applying any treaty excise tax waiver, no person would be relieved of the requirement to remit the excise tax, unless the parties to the transaction satisfied any requirements the Treasury may prescribe to ensure collection of tax due on any reinsurance of the risks. The technical explanation to H.R. 5270 explained that the above rule would apply to premiums paid to a foreign insurer entitled to treaty benefits under a treaty waiving the excise tax, whether or not that treaty had an anti-conduit clause. (Several tax treaties have anti-conduit provisions[**] that deny the insurance excise tax waiver with respect to premiums concerning risks that are reinsured with a person not entitled to a similar treaty exemption.) Furthermore, this provision would override the U.S.-United Kingdom tax treaty concerning the insurance excise tax and would be likely to result in retaliation by the United Kingdom.

[**] See, e.g., the U.S. tax treaties with France, Italy, Spain, and Germany.

IV. General Description of Reinsurance and the Reinsurance Market.

A. Reinsurance.

The hallmarks of insurance are risk shifting and risk sharing. An insurance company accepts the risk of loss in return for the payment by the insured of an insurance premium. Further risk shifting and risk sharing occurs through reinsurance. A reinsurance company accepts a share of the risks an insurance company has assumed, in return for payment of a premium. In many cases, the reinsurer has more capital and surplus and/or a broader market to facilitate diversification of risk.

There are numerous types of reinsurance arrangements. For instance, a facultative (policy-by-policy) reinsurance treaty reinsures the insurer's risks on an individual policy basis. Non-proportional reinsurance, also known as excess of loss reinsurance, is a form of reinsurance in which the reinsurer assumes the part of the insurer's losses that exceed a certain amount, against payment of the specially calculated premium. Under a proportional reinsurance treaty, premiums and losses of the insurer are shared proportionally by the insurer and the reinsurer. Under quota-share reinsurance, the reinsurer accepts a specified share of each risk of an insurer in a specified class of business. Under surplus reinsurance, the reinsurer reinsures risks over a specified amount. Other types of reinsurance arrangements also exist. For some of these complex insurance products, the portion that could be considered as attributable to underlying U.S. risks is sometimes extremely hard, if not impossible, to identify.

B. The Reinsurance Market.

Insurance provides a function which is critical for the operation of U.S. industry and commerce. To have a strong primary insurance market, it is essential for insurance companies to have access to reinsurance provided by companies with sufficient capacity to allow insurance companies to further shift and spread the risk of loss. In this context, "capacity" is the maximum amount of a risk that can be included in reinsurance, and is a function of the available surplus of the reinsurance company and the potential for economic reward given a specific level of risk.

The reinsurance market today is a global market. A U.S. insurance company can shop among both domestic and foreign reinsurance companies for the appropriate reinsurance coverage. This access by U.S. insurers to foreign reinsurance companies increases the capacity for insuring U.S. risks. Because particular types of coverages are unavailable or scarcely available from U.S. reinsurance companies, foreign reinsurance companies provide coverage that otherwise simply could not be obtained. For instance, foreign companies are acting as primary sources of reinsurance for medical malpractice, earthquake and hurricane, aviation, marine, nuclear, aerospace, and other coverage.

Even in the global marketplace U.S. insurers currently are experiencing difficulties in placing reinsurance, because of the recent high levels of losses experienced by the industry. We are all aware of the disasters, both natural and man-made, that all areas of our country seem to be experiencing. The insurance industry recognizes that it increasingly is susceptible to catastrophic exposures, as shown by the high losses sustained in 1992 from Hurricanes Iniki and Andrew, and the Northeast storms. In fact, 1992 was the worst year in history for catastrophic losses. As reported by Best's Review, in February, 1993:

> The dollar magnitude of 1992's catastrophes was staggering and contributed to the reporting of an estimated $34 billion in industry underwriting losses for the year.

> This record exceeded by 36% the previous record of $25 billion set in 1985.

"The Year of the Cats," Best's Review, February 1993, at 17.

With the devastating floods this summer in the mid-west, the March 1993 blizzard, the World Trade Center explosion and most recently Hurricane Emily, 1993 is also developing into a costly year for insurance companies.

Because of these unprecedented developments, U.S. insureds may soon have trouble obtaining affordable coverage. The choice facing insurance companies providing primary coverage is either to withdraw from the most catastrophic-prone areas, or purchase more reinsurance. See "Catastrophic Changes," Global Reinsurance, September-November 1992, at 177. When reinsurance is not available, or is not available at the right price, primary insurers are withdrawing their coverage. In Florida, Allstate Insurance Company announced that it would not renew policies for 300,000 Florida homeowners and other policy holders, because of its inability to obtain affordable reinsurance. Wall Street Journal, April 23, 1993, A-2. CNA will no longer write property insurance for large U.S. companies with multiple locations, because "their reinsurance treaty fell apart." See "CNA will close National Accounts Property Division," Journal of Commerce, April 19, 1993.

The scope of the pressures facing insurance companies can be gauged from these recent headlines:

- "Blizzard Claims Estimated at More than $1.6 Billion," Journal of Commerce, March 31, 1993.
- "Cigna Expects $25 Million in Blast Claims" Journal of Commerce, April 2, 1993.
- "Port Authority Pegs Towers Blast Cost at $600 Million." Journal of Commerce, April 8, 1993.
- "Florida Homeowners Face Big Premium Increases, Scarce Coverage," Journal of Commerce, April 16, 1993.
- "State Farm Halts Growth of Texas Property Coverage," Journal of Commerce, April 27, 1993.
- "Insurance Industry is Not Prepared For Another Disaster, Analyst Warns" Journal of Commerce, May 5, 1993.
- "Capacity Contractions Spark Concern for Reinsurers," Journal of Commerce, May 5, 1993.

Some have characterized 1993 as a time of reduced reinsurance capacity in the market in general. Analysts expect reinsurance companies either to increase prices or abandon altogether costly lines of coverage such as catastrophic reinsurance. See "Reinsurance to Strive to Improve Returns," Journal of Commerce, March 17, 1993. Overall, insurers could be facing a reduction of capacity in entire segments of the worldwide reinsurance market. See "Capacity Contractions Spark Concern for Reinsurance," Journal of Commerce, May 5, 1993. It is likely that an increase in the excise tax could substantially worsen what already appears to be a contracting market. This is particularly true in light of the highly publicized problems which the Lloyds market has experienced in the last few years.

V. Treasury Department Study of Competitive Effect on U.S. Reinsurers of U.S. Tax Treaty Exemptions for Foreign Insurers and Reinsurers.

Pursuant to a Congressional mandate included as section 1244 of the Tax Reform Act of 1986, the Department of Treasury in March of 1990 issued a report (the "Treasury Report") analyzing whether U.S. reinsurance companies are placed at a significant competitive disadvantage vis-à-vis foreign reinsurance companies, by reason of existing tax treaties between the United States and certain foreign countries which have provisions waiving the insurance excise tax.

The Treasury Report specifically noted that if the reinsurance market is tight, the economic burden of the excise tax may fall on U.S. policyholders rather than on the foreign reinsurers. Treasury Report, at 2.

According to the Treasury Report, there is no indication that waivers of the 1 percent excise tax on reinsurance premiums pursuant to tax treaties with countries that impose a full income tax cause a significant competitive disadvantage to U.S. reinsurers.

The Treasury Report also examined the consequences when no treaty waiver is available if the rate on reinsurance premiums were to be raised to 4 percent. The Treasury Report concluded that a 4 percent rate "would likely have a materially adverse impact on the relative profitability of U.S. business for many foreign reinsurance companies located in full-tax countries." (Treasury Report at 23). Moreover, reinsurance companies located in low-tax countries would also suffer substantially lower profitability results.

Based on its analysis, the Treasury testified at last year's hearings on H.R. 5270 regarding the proposal to increase the excise tax that it is "not convinced that a general rate increase is warranted at this time." Statement of Fred T. Goldberg, Jr., Assistant Secretary (Tax Policy), at 18-19 (July 21, 1992).

VI. Reasons Why the Insurance Excise Tax Rate Should Not Be Raised.

The existing 1 percent excise tax on reinsurance should not be raised any higher, for the following reasons:

1. Raising the Insurance Excise Tax Rate is Not Necessary to Protect the Competitive Position of U.S. Insurers.

As the Treasury Report concluded, U.S. reinsurers are not operating under a competitive disadvantage even when the existing 1 percent tax on reinsurance premiums is waived by treaty. Although the Treasury Report was not able to examine in detail the tax laws of each country, it did perform a relative after-tax return analysis of the results in several countries of a simplified reinsurance transaction, and based its conclusion on that analysis.

2. Raising the Insurance excise tax rate would have undesirable consequences to U.S. insureds.

If the excise tax were raised, foreign reinsurers would have two choices: either withdraw from the U.S. market altogether, or pass the increased costs on to U.S. insureds, in order to remain profitable. As previously discussed, the U.S. already is facing a period of tight reinsurance capacity that will continue for the foreseeable future. The withdrawal of foreign reinsurers from the U.S. market because of an increase in the insurance excise tax would only cause severe coverage gaps. The U.S. reinsurance companies simply do not have the capacity to accept all the risks for which U.S. insurers need reinsurance. U.S. insureds would consequently suffer, either because the cost of coverage would increase, or would not be available at any cost. Because U.S. businesses would be hesitant to "go naked" without coverage, economic activity in the U.S. would be hampered, making the recovery from the recession that much more difficult.

3. Our Trading Partners Would Retaliate.

Many of our major trading partners have made known their displeasure with past proposals to increase the tax rate. The trading partners view the proposals as tantamount to a tariff increase, and they would consider taking appropriate steps in response. Those countries with tax treaties with the United States containing the insurance excise tax waiver also viewed the proposals as unilaterally changing their treaties. For instance, Robin Wrenwich, the British Ambassador to the United States, wrote the Secretary of the Treasury regarding his government's concern that the provisions of H.R. 5270 abrogate the U.S.-U.K. income tax treaty.

Retaliatory measures by our trading partners would have a harmful effect on our overall economy, and could greatly damage international investment and trade. We assume that our trading partners would again view with displeasure legislation proposing to raise the insurance excise tax.

In addition to the potential for retaliation, enactment of the excise tax increase, with the other excise tax provisions contained in H.R. 5270, would result in a situation where companies located in certain countries would be disadvantaged compared with those companies located in countries qualifying for the lower tax rate or complete exemption. This would inevitably force companies to restructure their operations so as to be located in countries qualifying for exemption treatment, thus potentially causing H.R. 5270 to actually lose revenue rather than gain revenue.

VII. Conclusion.

For the above reasons, I urge the Committee to maintain the excise tax on reinsurance at its current rate.

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Mr. NEAL. I will now hear from Mr. Jarratt.

STATEMENT OF ROBERT JARRATT, EXECUTIVE VICE PRESIDENT AND CHIEF EXECUTIVE OFFICER, FLORIDA FARM BUREAU CASUALTY INSURANCE CO., AND FLORIDA FARM BUREAU GENERAL INSURANCE CO., GAINESVILLE, FLA., ON BEHALF OF THE NATIONAL ASSOCIATION OF INDEPENDENT INSURERS, ALLIANCE OF AMERICAN INSURERS, AND NATIONAL ASSOCIATION OF MUTUAL INSURANCE COS.

Mr. JARRATT. Mr. Chairman, my name is Robert Jarratt and I am CEO of two Farm Bureau insurance companies that engage in business in the State of Florida. I appear today to express concern and opposition of those for whom I appear to the proposed increase in the Federal excise tax imposed with respect to foreign insurance policies, which I will refer to today as the FET, which increase was contained in H.R. 5270.

While my testimony is on behalf of the National Association of Independent Insurers, of which my companies are members, the Alliance of American Insurers, and the National Association of Mutual Insurers, and while a discussion of overall market conditions and their relevance to the FET proposal are discussed later, I believe that the circumstances of my particular companies demonstrate why domestic property and casualty, or P&C insurers would be adversely affected by the 300 percent increase in the FET rate.

During 1991, my companies purchased $100 million of reinsurance coverage for 1992 at a cost of approximately $2.5 million. By 1992, when my companies purchased reinsurance coverage for 1993, the cost for $110 million of coverage had skyrocketed to approximately $6 million. The companies will soon need to purchase reinsurance coverage for 1994.

While we are very much concerned about what the price will be for that coverage, we are even more concerned about whether the amount of reinsurance coverage that we believe is needed by the companies will be available at any price.

To be sure, Florida has become one of the most difficult States for obtaining reinsurance coverage. However, the cost of catastrophe reinsurance has increased dramatically across the country. I know of other Farm Bureau companies where the cost of reinsurance coverage has jumped between 60 and 80 percent depending on geographic location. And I have seen reports of reinsurance costs in the range of 30 to 50 percent with retention increases in many cases doubling and tripling. The term “retention” refers to the amount of risk that an insurer retains itself and does not transfer to another through a reinsurance arrangement.

As explained in detail in our filed statement, P&C insurers and their policyholders would ultimately bear the burden of this proposal because as purchasers of foreign reinsurance, any increase in the FET rate will be passed through by affected foreign reinsurers directly to the U.S. insurers that purchase the reinsurance coverage. The insurers in turn will generally pass through to their policyholders at least a portion of the increased reinsurance costs attributable to the increased FET.

We believe that the foreign reinsurers will pass through the burden of the increased FET because of, one, the limited domestic capacity generally, and, two, the absolute unavailability of any domestic sources for specific types of reinsurance coverage.

For the domestic P&C companies that require catastrophe reinsurance, the market conditions just described result in such companies having little bargaining power at this time when negotiating with foreign reinsurers on pricing. Foreign reinsurers know this. Consequently, if the FET rate is increased, these foreign reinsurers which choose to continue devoting capacity to the U.S. market will simply add the amount of the FET increase to the existing price of the coverage. Indeed, even the Reinsurance Association of America, the primary proponent of the FET proposal, acknowledges that the burden of the increased FET would ultimately fall on the domestic purchaser of foreign reinsurers.

While the domestic reinsurers contend the industry is suffering from a competitive disadvantage, recent reports indicated that the net amount of premiums written by U.S. reinsurers during the first 6 months of 1993 was $6.4 billion, representing an 11.7 percent increase compared to the first half of 1992.

Another concern that the domestic P&C insurers have with the FET proposal is the effect on international trade. Many of our country's trading partners view the FET proposal as protectionalist and in direct violation of existing treaties. Consequently we are very much concerned about the possibilities of those companies retaliating against U.S. business.

Retaliation could come in many forms, including limiting domestic P&C companies' access to foreign markets, imposing reciprocal access taxes on U.S. insurance or reinsurance covering risks in foreign markets, and unilaterally abrogating whatever concessions that were made in consideration of obtaining the FET treaty waiver from the United States. We submit that these risks clearly outweigh the reinsurers' asserted justification for government protection.

Finally, we urge that you consider the administrative nightmare this proposal would create for both the taxpayers and the IRS. The proposal would require that the domestic P&C insurers ascertain the destination of all risks that were reinsured.

This tracing requirement would apply not only to all risks or parts thereof that are reinsured by initial reinsurers, but also to the second and third and other levels of reinsurance that might be involved with respect to each risk that a property and casualty company reinsures because the current practice reinsurance is to bundle together a collection of risks, to then reinsure a portion thereof with other reinsurers that in turn might do the same.

The tracing requirement under the proposal would be impossible to carry out in many cases. When one attempts to apply the FET proposal to the real world, it becomes obvious that the proposal will not work and could not be administered.

The P&C industry respectfully urges that the FET proposal which would quadruple the FET unilaterally, override carefully negotiated treaties, and effectively transfer to the P&C insurer a portion of the reinsurer's tax burden be rejected.

Thank you.

Mr. NEAL. Thank you, Mr. Jarratt.

[The prepared statement follows:]

TESTIMONY OF ROBERT JARRATT
ON BEHALF OF
THE NATIONAL ASSOCIATION OF INDEPENDENT INSURERS
THE ALLIANCE OF AMERICAN INSURERS
AND
THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Mr. Chairman and Members of the Subcommittee, my name is Robert Jarratt, and I am CEO of two small insurance companies that are engaged in business in the state of Florida. I appear today to express the concern and the opposition of those for whom I appear to the proposed increase in the federal excise tax ("FET") imposed with respect to foreign insurance policies, which increase was contained in H.R. 5270, introduced in the 102nd Congress.

While my testimony is on behalf of the National Association of Independent Insurers, of which my companies are members, the Alliance of American Insurers, and the National Association of Mutual Insurance Companies, and while a discussion of the overall market conditions and their relevance to the FET proposal are discussed later, I believe that the circumstances of my particular companies provide meaningful insight into the reinsurance challenges that the property and casualty ("P&C") industry currently faces, which is relevant to why P&C insurers oppose the proposed FET increase.

During 1991, my companies purchased $100 million of reinsurance coverage for 1992, at a cost of approximately $2.5 million. By 1992, when the companies purchased reinsurance coverage for 1993, the cost for $115 million of coverage had skyrocketed to approximately $6 million. The companies will soon need to purchase reinsurance coverage for 1994. While we are very much concerned about what the price will be for that coverage, we are even more concerned about whether the amount of reinsurance coverage that we believe is needed by the companies will be available at any price.

To be sure, Florida has become one of the most difficult states for obtaining reinsurance coverage. However, the cost of catastrophe reinsurance has increased dramatically across the country. I know that for other Farm Bureau companies, the cost of reinsurance coverage has jumped by between 60 and 80 percent, depending on geographic location. And, I have seen reports of reinsurance cost increases in the range of 30% to 50% , with "retention" in many cases doubling.[1] The term "retention" refers to the amount of risk that an insurer retains itself, and does not transfer to another through a reinsurance arrangement.

A reported experience of Farmers Insurance Group illustrates the plight of a company that encounters the current "retention" dilemma. Farmers Insurance Group had historically purchased its reinsurance from the Lloyds of London market. Recently, Farmers was advised by its reinsurers that as a condition of its reinsurance renewal, Farmers would need to double its "retention" to $200 million.[2] Farmers' treasurer was quoted as saying that in the company's entire history, it has never experienced a catastrophe loss of that magnitude. In essence, the new reinsurance arrangement offered to Farmers Insurance Group would provide the insurer less reinsurance protection that what the company desired.

Some market analysts believe current market conditions threaten the very survival of many P&C insurers.[3] Factors contributing to this plight are the recent large catastrophe losses[4] (for example, the $18 billion in insured losses from hurricane losses) , low interest rates, low commercial insurance rates, the expansion of surplus lines markets and escalating catastrophe reinsurance rates.[5]

It is within the context of the "real world" just described that the merits of the proposed FET increase need to be evaluated.

1. P&C insurers, and ultimately their U.S. policyholders, would be adversely affected by this proposal because, as purchasers of foreign reinsurance, any increase in the FET rate will be "passed through" by affected foreign reinsurers directly to the U.S. insurers that purchase the reinsurance coverage and, to some extent, to their policyholders

The reason P&C insurers would be adversely affected by the proposal to increase the FET is that if the FET is increased, the P&C companies – and, to some extent, their policyholders – will ultimately bear the burden of the tax increase.

Because of 1) the limited domestic capacity generally, and 2) the absolute unavailability of any domestic sources for specific types of reinsurance coverage, many P&C companies currently have no choice but to purchase much of their reinsurance from foreign companies. Since many such P&C companies require catastrophe reinsurance, they have little bargaining power at this time when negotiating with foreign reinsurers on pricing. Foreign reinsurers know this. Consequently, if the FET is increased, those foreign reinsurers which choose to continue devoting their capacity to the U.S. market will simply add the amount of the FET increase to the existing price of coverage.

A recent article analyzing the causes and effects of the limited reinsurance capacity currently available[6] indicates that the major factors contributing to the diminished capacity are 1) the withdrawal from the market of substantial amounts of capital, and 2) the severe financial problems currently experienced by the Lloyds of London market. The article notes that executives from some of the world's largest reinsurers expect the contracting capacity for catastrophe and other forms of property reinsurance to continue, applying upward pressure on reinsurance rates.

While current market conditions indicate that foreign reinsurers would likely "pass through" the burden of an increased FET, they represent only one part of the analysis. In some situations, the foreign reinsurer would be expected to "pass through" the burden of an increased FET, irrespective of market conditions. As pointed out in the September 1989 General Accounting Office Report on the FET[7] (the "1989 GAO Report"), the reinsurance provided by some foreign reinsurers is "complementary" to U.S. reinsurers. "Complementary" reinsurance coverage refers to coverage for types of risks that is not offered by any U.S. reinsurer. There is no question that a P&C insurer in need of a particular type of reinsurance that is not offered by any U.S. reinsurer would not likely succeed in convincing the foreign reinsurer to absorb the burden of an increased FET.

The 1989 GAO report provides an anecdotal account of the plight of one specific company that needed a specific type of reinsurance that only a foreign reinsurer was willing to provide. Mortgage Guaranty Insurance Corporation (MGIC) is in the business of providing a type of insurance that protects banks and savings and loans against losses when homeowners default on mortgage payments. The GAO report found that by 1984, MGIC was approaching the point where it could not take on any new business without either increasing its capital or obtaining reinsurance to mitigate its risk exposure. After failing in its attempts to raise capital, MGIC explored the possibility of obtaining reinsurance. None of the U.S. reinsurers that MGIC approached would provide any reinsurance to cover the type of risk that MGIC underwrote. With no other alternative, MGIC ultimately obtained the reinsurance it needed from foreign companies. An increase in the FET rate would, without question, translate into a direct increase in cost for companies such as MGIC, which have no alternative but to purchase the reinsurance they need from foreign sources.

As the foregoing demonstrates, domestic P&C companies and their policyholders will almost certainly bear the burden of an increased FET. Whether because of 1) limited capacity relative to demand for reinsurance, or 2) a specific type of reinsurance that a company needs is not available from any domestic source, the reinsurance market forces clearly indicate that affected foreign reinsurers would "pass through" to reinsurance purchasers any increase in the FET.

Indeed, even the Reinsurance Association of America ("RAA"), the primary proponent of the FET proposal, acknowledges that the burden of an increased FET would ultimately fall on domestic purchasers of foreign reinsurance. Specifically, in written RAA testimony submitted in connection with a hearing in 1990 on a similar FET proposal, the RAA stated for the record that an increase in the FET "primarily would be absorbed by the direct insurers and/or the insureds (as is the case currently)."[8]

Because of the fact that any increase in the FET will likely be borne ultimately by domestic P&C companies that purchase foreign reinsurance, such companies, and their policyholders, have a direct stake in the outcome of any proposal to increase the FET rate.

2. Another possible consequence of an increase in the FET, that would be far worse, and is of more concern to P&C insurers, is that foreign reinsurers that currently provide the hard-to-place reinsurance (coverage that is not available from any U.S. reinsurers) would simply withdraw from the U.S. market.

"When reinsurance is unavailable, insurers are forced to choose between scaling back operations and retaining more risk. For some companies ... , however, neither choice was viable and they were forced to merge to avert insolvency."[9]

Unfortunately for many P&C companies, the debate over the soundness of raising the FET rate goes beyond the question of whether it is appropriate that P&C insurers be required to pay more for reinsurance. Framing the issue in that way presumes that a quadrupling of the FET would not result in foreign reinsurers withdrawing from the U.S. market. If this presumption is found to be wrong, the consequence to many P&C companies would be fatal. And, this is no mere hypothetical consideration.

A report on a recent Standard & Poor's survey of 69 professional reinsurers[10] revealed that the global reinsurance market is expected to continue contracting. Consolidation and withdrawal from the market is expected to add to the current capacity crunch. Indeed, some of the withdrawals from the reinsurance market that have already occurred have been remarkable. For example, Netherlands Reinsurance Group, which recently withdrew from the non-life market last year received $998.3 million in net written premiums and ranked No. 12 in the annual Business Insurance ranking for the year.

While theoreticians might, from the detached confines of their offices, debate the question of whether a foreign reinsurer might actually withdraw its capital from the U.S. market in response to a 300% increase in the FET, P&C companies – whose continued viability depends on foreign reinsurers – cannot risk such a withdrawal. That consequence would bring them to financial ruin.

Because of the tremendous risk to which the proposed FET increase exposes P&C companies that rely on foreign reinsurers, it is submitted that the domestic reinsurers should bear an extremely heavy burden in justifying the propriety of an increase in the FET, and particularly a 300% increase. In other words, the reinsurers should be required to demonstrate that *their* continued viability as reinsurers is contingent on the FET increase that they support. To impose any lesser burden would represent a policy decision that the possible destruction of a portion of the P&C industry is an acceptable risk to assume in exchange for enhancing the profitability of reinsurers.

3. The domestic reinsurance industry has demonstrated no compelling need for such a drastic increase in the FET rate, especially under current market conditions, where the demand for reinsurance far exceeds available capacity.

Rather than demonstrating a compelling need for an FET rate increase, recent evidence supports the conclusion that the domestic reinsurance industry is prospering. Recent reports indicate that the net amount of premiums written by U.S. reinsurers during the first six months of 1993 was $6.4 billion, representing an 11.7% increase compared with the first half of 1992.[11]

What is more, an FET increase would accomplish little if any change in the amount of reinsurance that domestic P&C companies purchase from U.S. reinsurers. The amount of such purchases has always been limited by the supply, that is, by the amount and types of reinsurance that the domestic reinsurers offer. Indeed, as the P&C industry testified in 1990 and again during 1992, domestic P&C companies would almost always prefer purchasing reinsurance from U.S. reinsurers because:

1. it is more difficult to evaluate a foreign reinsurer's financial security and the ability to pay claims;
2. medium and small-sized insurers generally do not possess the in-house expertise that is needed to deal with foreign reinsurers;
3. many foreign reinsurers have become more selective as to the type of U.S. risks they will reinsure, due to, among other things, the U.S. litigation situation; and
4. obtaining payment and terms of coverage from domestic reinsurers is easier than from foreign reinsurers.

The foremost reasons previously noted for why domestic P&C insurers have traditionally turned to the foreign reinsurance market are that 1) the domestic market lacks the capacity to handle all the reinsurance needs of P&C companies, and 2) domestic reinsurers do not offer all the types of coverage that is needed. Current market conditions have only exacerbated these problems.

Indeed, current market conditions are so strong for reinsurers, the president and CEO of Munich American Reinsurance Co. of New York, who is also Vice Chairman of the RAA, was reported as proudly announcing recently that large U.S. reinsurers are gaining additional clout to determine which risks they will accept and the terms of the arrangements.[12] He also opined that this trend is expected to continue. In other words, the competitive position of U.S. reinsurers is strong, and is expected to strengthen further.

We submit that current market conditions confirm the wisdom of the admonishments contained in the Treasury Department report on the FET,[13] that one should not attempt to evaluate the relative competitive positions of U.S. and foreign reinsurers by taxes alone.[14] While we do not concede that the Internal Revenue Code (the "Code") places U.S. reinsurers at a competitive disadvantage relative to their foreign competitors, we do submit that current market conditions heavily overshadow any market distortions that the Code might create.

In sum, the domestic reinsurance industry is not in need of further government protection along the lines of an increased FET. No rational basis currently exists to justify increasing an excise tax on foreign competitors in order to protect the now formidable domestic reinsurance industry.

4. Without a showing that the tax increases of which the U.S. reinsurers complain affected their industry more severely than the U.S. P&C industry, we submit that it would be unconscionable to shift a portion of the reinsurers' tax burden to the P&C industry -- which the Reinsurance Association of America candidly admits is a major objective of the proposed FET increase.

One of the RAA's arguments for an FET increase is that such an increase is necessary in order to inflate market reinsurance prices to a level that would be sufficient for U.S. reinsurers to completely "pass through" the burden of tax increases that were imposed on the industry by the Tax Reform Act of 1986 (the" 1986 Tax Act"). The written testimony that the RAA submitted in connection with a 1990 hearing concerning a proposed FET increase explicitly confirms this:

> To remain competitive in the marketplace, domestic reinsurers need to increase premium rates. Yet competition from foreign companies immune from the 1986 Act constrains the ability of U.S. companies to increase their premiums.
>
> ...
>
> The message from the RAA model is clear. As a result of the 1986 Act, domestic reinsurers must increase rates substantially to maintain an after-tax rate of return sufficient to permit companies to remain competitive in the capital marketplace and to maintain investment support. Failure to compensate through

> rate increases for the impact of the 1986 Act will reduce after-tax return ... Increasing the excise tax and its universal collection would substantially diminish the unintended financial advantage now afforded non-resident foreign reinsurers....
>
> Although the RAA acknowledges that an increase in the excise tax would raise the cost of foreign reinsurance, this is not an evil inherent in the proposal but a simple manifestation of the Congressional policy of the 1986 Act ....[15]

The RAA is candid and unambiguous in its request that the government intervene in the reinsurance market, through the FET, to artificially increase the domestic price of reinsurance, so that the domestic reinsurers will be able to "maintain an after-tax rate of return sufficient to permit companies to remain competitive in the capital marketplace and to maintain investment support."

In evaluating the RAA's pleas, however, one needs also to consider the fact that the 1986 Tax Act changes of which RAA complains were also imposed on P&C insurers. Consideration of the impact of an FET increase on P&C companies is essential since, for reasons set forth above, the P&C companies will ultimately bear the burden of the increased FET.

While there is no question that the 1986 Tax Act changes imposed a significant extra cost on U.S. reinsurers, the Act also imposed a significant extra cost on U.S. primary insurers. Reinsurers complain that the "playing field" is not level now, because while the 1986 Tax Act increased the tax burden on domestic reinsurers, no similar tax increase was imposed on foreign reinsurers. The RAA argues that a consequence of foreign reinsurers not being burdened with a tax increase comparable to what the 1986 Tax Act imposed on domestic reinsurers, is that the foreign reinsurers have no cause to raise their reinsurance prices. Without the foreign competitors increasing their prices, the domestic reinsurers are effectively denied the opportunity to do so. Consequently, the domestic reinsurers argue that they have been unfairly denied the opportunity to increase prices sufficiently to "pass through" to reinsurance purchasers the full burden of the 1986 Tax Act.

However, the reinsurers are not alone with that problem. Market forces,[16] combined with regulatory obstacles,[17] have also denied P&C insurers the ability to fully pass through the burden of the 1986 Tax Act. Since the same forces that have denied insurers the opportunity to fully pass through to consumers the 1986 Tax Act increases still exist, such companies would undoubtedly not be able to fully pass through to policyholders the additional burden that will result from increased reinsurance prices.

However, whether the burden of an increased FET would ultimately be borne by policyholders, P&C companies, or a combination thereof, is not the point here. The issue that the FET proposal poses to the Congress is whether it is appropriate at this time to transfer part of the 1986 Tax Act tax increase affecting U.S. reinsurers to U.S. insurers and possibly to policyholders. Rhetoric aside, that is the issue.

5. Inasmuch as the FET proposal is viewed by many of this country's trading partners as protectionist, and in direct violation of existing treaties, we are very much concerned about the potential for retaliation. The retaliation could be in many forms, including limiting domestic P&C companies' access to foreign markets, imposing reciprocal excise taxes on U.S. insurance or reinsurance covering risks in foreign countries, and unilaterally abrogating whatever concessions that were made in consideration of obtaining the FET treaty waiver from the U.S.

Concerns about the impact on trade that an increase in the FET might bring were well expressed in the 1989 GAO Report:

> An increase in the excise tax, coupled with the elimination of excise treaty waivers, may encourage foreign countermeasures, jeopardizing the ability of U.S. insurers to compete in other markets.[18]

We very much share the concerns expressed by the GAO. While some might contend that the FET provision contained in H.R. 5270 is consistent with all existing U.S. treaty obligations, we believe, and it is our understanding that some foreign countries would contend, that the provision violates existing U.S. treaties.

One aspect of the provision whose consistency with existing treaties is especially controversial is the one which conditions the availability of the FET waiver on the effective tax rate imposed on a foreign reinsurer being "substantial" in relation to the effective U.S. tax rate (the "conditional FET waiver provision"). This provision has stirred controversy because some foreign jurisdictions have negotiated in their respective treaties with the U.S. an unconditional FET waiver. It is submitted that to require the conditional FET waiver provision to be satisfied by a reinsurer that is taxed in a jurisdiction whose treaty with the U.S. contains an unconditional FET waiver reveals an obvious problem of inconsistency.

The FET proposal could create trade difficulties irrespective of how one resolves the controversial conditional FET waiver provision. Because of the well-documented purpose sought to be achieved by an increase in the FET, that is, to enhance the competitive position of U.S. reinsurers relative to their foreign competitors,[19] the proposal is viewed by many as unabashedly protectionist. Indeed, one would suspect that from the perspective of foreign competitors, a 300% increase in the FET is in many respects the equivalent of an additional 3% tariff.[20] To a foreign reinsurer subject to the FET increase, the bottom-line effect of either would be identical, that is, a 3% government-imposed increase in their cost of doing reinsurance business in the U.S.

Furthermore, one must acknowledge that while the FET excise tax waiver is without question a benefit to foreign businesses, it represents a concession given in exchange for an offsetting benefit to U.S businesses. Unilateral nullification of the excise tax waiver could well result in the affected foreign jurisdiction abrogating the offsetting benefit that had been granted to U.S. businesses in exchange for the FET waiver.

Because of the current climate of seemingly endless trade tensions, for example, the controversy pending over the State of California's taxation of multinational companies, the Uruguay Round, disputes over aircraft subsidies, the continuous trade negotiations with Japan, and countless others, we submit that it is wrong to compound such tensions by enacting the FET increase proposal.

And, in addition to the widely publicized major trade developments that could be affected by enactment of the FET proposal, one must also consider the proposal's impact on trade issues of a smaller dimension, but that are of much concern to specific industries. For example, efforts are currently underway to expand the U.S. insurance presence in Japan and in parts of Asia. Japan's Ministry of Finance is currently in the process of planning legislation for new taxation of insurance and reinsurance premiums paid to foreign companies.[21] Furthermore, some companies are now positioning themselves for possible entry into Laos, whose government-imposed monopoly will expire in 1995, thereby opening that market to foreign companies. [22] Insurers are also anxiously awaiting progress in opening the Mexican market to foreign insurers, an opportunity described by an advisor to a major U.S. insurer as "extraordinary."

We submit that with all the trade tensions and potential opportunities now at issue, some of which having many hours of delicate negotiations lying ahead, it would be inadvisable for the U.S. to take any action that might result in other countries questioning whether the U.S. can be relied on to honor the commitments that it makes. From the perspective of some foreign countries, a unilateral increase in the FET, especially when combined with a new "conditional FET waiver" provision, might indicate that the U.S. cannot be trusted to abide by the treaties that it negotiates.

6. Even if there were some justification for modifying the FET, the proposal contained in H.R. 5270 is unworkable.

We concur with the evaluation given the FET proposal by the Treasury Department in its prepared statement before a 1992 House Ways and Means Committee hearing on H.R. 5270:

> we do not support the proposal because we do not believe that it can be administered fairly and effectively. For example, we are seriously concerned about the burden of the numerous closing agreements that would be required and about the difficulty of determining the effective rate of foreign tax in a multitude of countries. We believe that the proposal would further the goal of [preserving] the U.S. tax base to an uncertain extent and only at unacceptable costs to the goal of administrability and simplicity.[23] (Emphasis added).

As proposed in H.R. 5270, the increased FET that would apply to reinsurance premiums paid to a foreign reinsurer could be avoided only if both of the following requirements are met:

1. the income (including investment income) relating to the policy of reinsurance is subject to foreign tax at an effective rate that is "substantial" in relation to the U.S. income tax; and

2. the reinsured risk is not reinsured (directly or indirectly) to a company that is not subject to a "substantial" tax on the income relating to the reinsurance policy (the "anti-conduit" rule).

With certain exceptions, any party to a transaction subject to the FET could be held responsible for remitting the applicable FET. Consequently, in cases where the FET is not applicable, all parties to a transaction would need to be able to show that both of the requirements set forth above are met. We submit that proving either of the requirements could be extremely difficult, and very demanding from an administrative perspective, even if they could be accomplished.

The first requirement apparently would be satisfied if it can be shown that the foreign reinsurer is subject to an effective rate of tax that is at least 50 percent of the applicable U.S. effective tax rate. In cases where the foreign effective rate of tax is neither clearly above nor clearly below the 50% threshold, this requirement will result in hopeless controversy. As the GAO observed in its 1989 report:

> [b]ecause of differences in the way the various countries define taxable income, we could not compare the tax burden of reinsurers from different countries.[24]

The GAO's candid admission of its inability to undertake the comparison that would be demanded of taxpayers by the FET proposal provides an indication of the hopeless confusion that would surely reign as taxpayers and the Internal Revenue Service sought to resolve the issue.

Furthermore, even if it were possible to compare the tax burdens of different countries, a country's tax laws are not static. The requirement would require parties to foreign reinsurance transactions to constantly monitor the tax laws of each country that imposes a tax on the income of either the reinsurers with which they deal or the reinsurers with whom their reinsurers deal, and so on.

The second requirement, the anti-conduit rule, is also unworkable. The implementation of this requirement contemplates a procedure under which foreign reinsurers would enter into "closing agreements" with the Treasury Department in order to ensure compliance. As noted above, the Treasury Department testified that the administrative burden created by this requirement would be excessive.

The noted compliance problems become strikingly evident when the proposal is considered within the context of the "real world." In the "real world," it is common for a reinsurer to retrocede all or a portion of the specific risks that it assumed from different insurers to other reinsurers. The other reinsurers, in turn, might retrocede to still other reinsurers all or a portion of the risks they respectively assumed, and so on.

In many cases, an insurer would find it impossible to determine the destination of the entire collection of risks that it reinsured. To avoid the FET under the proposal, each reinsurance of each risk, and portions thereof, would need to be carefully traced through each and every company involved. And, a determination of relative tax burdens (wnich the GAO confessed it could not perform) would need to be performed for all countries that tax one or more of the foreign reinsurance companies that assumed any portion of the risk.

In sum, when one attempts to apply the FET proposal to the "real world," it becomes obvious that the proposal would not work, and could not be administered.

The P&C industry respectfully urges that the FET proposal, which would quadruple the FET, unilaterally override carefully negotiated treaties, and effectively transfer to P&C insurers a portion of the reinsurers' tax burden at a time when reinsurers are boasting strong first-half increases while P&C insurers struggle to remain viable, be rejected.

If Subcommittee Members have any questions, I would be pleased to seek to answer them. Thank you for the opportunity to present this testimony on a matter of such serious concern to the P&C industry.

[1] Business Insurance, July 19, 1993, at 58 .

[2] Ferraiolo, Walking The Reinsurance Tightrope, Best's Review (Property/Casualty) 35, 94 (August 1993) ("Ferraiolo").

[3] Business Insurance, May 3, 1993, at 38.

[4] A recent article described the recent spate of catastrophes as "beginning with the Los Angeles riots, followed by the Chicago flood, a record number of tornadoes (1,300), numerous hailstorms in the Midwest and Southeast and, on August 24, a shot that was heard around the world, Hurricane Andrew, which struck Florida and Louisiana. Adding insult to injury, Mother Nature delivered a crowning blow to the industry with Hurricane Iniki in Hawaii, and just three weeks before year end battered the northeast coastline with a nor' easter December 11–13, followed by an ice storm December 21." Snyder, The Year of the Cats, Best's Review (Property/Casualty) 15 (February 1993. The author estimates that the industry during 1992 absorbed more than $22 billion in catastrophe-related losses. Id. at 16.

[5] Business Insurance, May 3, 1993, at 38 (emphasis added).

[6] Business Insurance, August 30, 1993, at 55.

[7] General Accounting Office, The Insurance Excise Tax and Competition for U.S. reinsurance Premiums, 29 (GAO/GGD-89-115BR, September 1989) ("1989 GAO Report").

[8] Statement of Andre Maisonpierre, President, Reinsurance Association of America, Hearing of the Select Revenue Measures Subcommittee on Proposed Increase of Federal Excise Tax on Reinsurance Premiums Ceded Abroad, February 21, 1990 ("Maisonpierre Statement").

[9] Ferraiolo, supra note 2, at 35.

[10] Business Insurance, August 30, 1993, at 55.

[11] Business Insurance, August 30, 1993, at 2. According to an article in The Journal of Commerce, August 25, 1993, the impressive market gains realized by U.S. reinsurers are attributable to the shrinking capacity for property-catastrophe reinsurance in the London market, coupled with an increase in demand for the coverage.

[12] The Journal of Commerce, August 25, 1993.

[13] Treasury Department , Report To Congress On The Effect On U.S. Reinsurance Corporations Of The Waiver By Treaty Of The Excise Tax On Certain Reinsurance Premiums, (March 30, 1991)("1991 Treasury Report")

[14] 1991 Treasury Report , supra note 13, at 2 (emphasis added). The Treasury Report was in a sense prescient in cautioning that, the "competitive effects of [the different regulatory requirements and other] non-tax factors may easily dominate the effects of differences in tax laws." Id.

[15] Maisonpierre Statement, supra note 8.

[16] As pointed out in Snyder, The Year of the Cats, Best's Review (Property/Casualty) 15, 17 (February 1993), while the industry entered a soft underwriting market phase in 1987, the industry's underwriting results have slowly deteriorated since then, from a combined ratio of 104.6 in 1987, to a ratio of 108.8 in 1991. By 1992, the industry's combined ratio had spiked to an estimated 114.8, due to the major catastrophes, a level surpassed only twice before.

[17] E.g. the State of California's Proposition 103, that called for a premium rate roll-back on certain lines of insurance.

[18] 1989 GAO Report, supra note 7, at 3.

[19] E.g., Maisonpierre Statement, supra note 8; and 1989 GAO Report supra note 7, at 19.

[20] The additional FET would generally not be creditable against the foreign reinsurer's domiciliary income tax, see, e.g., 1991 Treasury Report, supra note 13, at 3. .

[21] World Insurance Forum: Japan, Best's Review (Property/Casualty) 66, 68 (September, 1993).

[22] Skully, Opportunity in an Unexpected Place, Best's Review (Property/Casualty) 21 (September, 1993).

[23] Statement of Assistant Treasury Secretary for Tax Policy Fred Goldberg Before House Ways and Means Committee at Hearing on HR 5270, "Foreign Income Tax Rationalization and Simplification Act of 1992," July 21, 1992 (Emphasis added).

[24] 1989 GAO Report, supra note 7, at 27.

Mr. Neal. Mr. Rahn.

STATEMENT OF ROBERT W. RAHN, COUNSEL, AMERICAN NUCLEAR INSURERS, ON BEHALF OF AMERICAN INSURANCE ASSOCIATION, MUTUAL ATOMIC ENERGY LIABILITY UNDERWRITERS, AND MAERP-REINSURANCE ASSOCIATION

Mr. Rahn. Mr. Chairman, good afternoon. I am Robert Rahn, counsel to American Nuclear Insurers of West Hartford, Conn. I appear today on behalf of the American Insurance Association to present the particular and perhaps unique perspective of the nuclear insurance pools on how the proposed quadrupling of the FET would impact U.S. consumers in ways that Congress may not have considered and would not likely intend.

The insurance industry created three pools at the urging of Congress that we provide insurance to meet the requirements of the 1957 Price-Anderson Act. Today these pools consist of approximately 180 stock and mutual insurance companies in the United States.

We operate as pools because the large amounts of insurance and the specialized underwriting and loss control techniques required to write nuclear insurance simply could not be provided by individual insurers. The pools provide nuclear liability insurance for all 115 commercial nuclear power plants in the United States. This lets the power plants meet Price-Anderson public protection requirements in the event of a nuclear incident such as the one we had at Three Mile Island in 1978.

We also provide insurance designed to comply with a U.S. Nuclear Regulatory Commission mandate that if there is a serious nuclear accident at any reactor, funds will be available to stabilize that reactor and to decontaminate the site.

When the pools were being formed, we gathered all available insurance capacity that we could from financially strong U.S. insurance companies, those who were willing to assume this new risk. Similarly, we invited strong U.S. reinsurance companies to stand behind them. Then we turned not by choice but out of necessity to the worldwide reinsurance market for the rest of the capacity and the spread of risk we needed.

Back in 1957, we were able to attract over two-thirds of the capacity we needed from U.S. sources. Today the situation is reversed. We must depend upon literally hundreds of overseas reinsurers all around the world for over 72 percent of our total capacity of just over $1.5 billion.

This has come about because the values of those power plants and the dollar amounts of financial protection required by Price-Anderson and by the NRC have far outstripped the available domestic capacity. With this background, I think you can see why the proposed FET increase troubles us.

Our major concern is that it would cause our overseas reinsurers, hundreds of them, to rethink their commitment to us and perhaps decide to sell their capacity where taxes are not a problem. If enough of those reinsurers did that, we would no longer be able to provide the current level of protection that nuclear reactor operators must have by law.

On the other hand, if they do stay with us, they are likely to demand higher prices. There is simply no other realistic alternative: Reduced capacity or higher prices.

Perhaps we could find other qualified reinsurers, ones that have not been attracted at our present premium levels. We would very likely have to pay an even higher price to attract them. In any case, we would have to pass whatever the increase is on to the nuclear utilities. They in turn would have to pass their increased costs on to the American consumers of electricity. Because in many cases no one can say whether a given kilowatt of electricity comes from a nuclear plant or a nonnuclear plant, that increase would be passed to almost all of us.

Some proponents of the increase argue that it would raise revenue painlessly because the tax would be paid by foreign reinsurers. Others say it would benefit U.S. reinsurers by "leveling the playing field" and therefore bring back business they have lost to reinsurers overseas. I did not come to engage in the overall debate. My goal is simply to focus attention on two points: One, the fact that this tax increase would not be painless to U.S. consumers as some claim. Consumers would wind up paying for it in their electric bills.

And two, there is some reinsurance business, particularly nuclear, that this tax measure could not possibly bring back from overseas because we already use all available U.S. capacity that meets our standards.

It has been suggested also that our reinsurers simply negotiate closing agreements with the IRS to avoid the FET. While a few of our larger reinsurers overseas have done that, they did so as part of their overall business plan involving other lines of business in the United States.

Most of our hundreds of overseas reinsurers are reluctant to go through the complex process necessary to negotiate a closing agreement, particularly if nuclear is the only or almost the only business they have in the United States. They can simply take their capacity elsewhere with less trouble and expense.

To summarize, from the perspective of the U.S. nuclear insurance pools, this increase would undermine our ability to provide adequate insurance to the electric utilities, insurance they need to comply with the Federal requirements of Price-Anderson and the NRC. It would either reduce the availability of foreign reinsurance, which we must have because U.S. insurance and reinsurance capacity is not sufficient, or increase the cost of reinsurance, or both. Either way, U.S. consumers and not foreign reinsurers would bear the burden.

Thank you, Mr. Chairman, for the opportunity to share our views.

Mr. NEAL. Thank you very much, Mr. Rahn.

[The prepared statement follows:]

TESTIMONY OF ROBERT W. RAHN
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
SEPTEMBER 21, 1993

Mr. Chairman, Members of the Subcommittee, Ladies and Gentlemen, good morning.

I am Robert W. Rahn, Counsel to American Nuclear Insurers (ANI), of West Hartford, Connecticut. I appear today on behalf of the American Insurance Association to present the particular perspective of the three nuclear insurance pools on how the proposed quadrupling of the FET, from the present 1% to 4%, would impact U.S. consumers in ways the Congress may not have considered and would not likely intend.

More specifically, I am testifying on behalf of ANI, and its sister organizations Mutual Atomic Energy Liability Underwriters (MAELU) and MAERP Reinsurance Association. These are cooperating "pools" of approximately 180 U.S. Property-Casualty insurers. At the urging of Congress, the insurance industry created these three pools to provide insurance that would meet the requirements of the Price-Anderson Act of 1957. We have been insuring nuclear risks for 36 years now.

Our pools provide nuclear energy liability insurance to the operators of all of the roughly 115 commercial nuclear power plants in the U.S. This lets them meet Price-Anderson's financial protection requirements that are designed to protect the public in the event of a nuclear accident at one of those plants. I'm sure Three Mile Island comes to everyone's mind; yes, we insured that.

Reactor operators also purchase our property insurance to comply with a U.S. Nuclear Regulatory Commission (NRC) mandate that there be adequate funds available, in the event of a serious nuclear accident, to stabilize the reactor and decontaminate the site to a safe level.

We operate as "insurance pools" because the large amounts of insurance, and the specialized insurance underwriting and loss control techniques needed for nuclear risks, simply could not be provided by individual insurers. When the pools were forming, we gathered all available insurance capacity from highly-rated U.S. insurers willing to assume this new risk. Similarly, we invited financially strong U.S. reinsurance companies to stand behind the companies that would actually issue the policies. After assembling all such domestic capacity, we turned - not by choice, but of necessity - to the worldwide reinsurance market to obtain the additional capacity and "spread of risk" we needed to provide this new kind of insurance in a sound and responsible manner.

We have seen the geographic sources of our capacity to write nuclear insurance change markedly over the past 36 years, as the values of those plants and the dollar amounts of financial protection required by Price-Anderson and the NRC have increased. In 1957, we were able to attract over two-thirds of the capacity we needed from U.S. insurers and reinsurers. Today the situation is reversed; we must depend upon literally hundreds of reinsurers overseas to provide almost 72% of our capacity. That translates to $1.1 billion out of our present total capacity of over $1.5 billion. To assemble this reinsurance we must go to many countries around the world. (To illustrate: we are now reinsured by over 100 British companies and Lloyd's syndicates; 65 German; 72 Spanish; 22 Finnish, etc.) Although we must go far to get it, we have been successful in meeting the insurance needs of our customers, the electric utilities and those who provide services to them, to protect both the public and their own property.

With this background I think you can see why the proposal to increase the reinsurance excise tax troubles us. Our major concern is that a fourfold increase in the FET would cause our overseas reinsurers to rethink their commitment to us. One need not be a mathematician or an economist to see that this could lead either to reduced insurance capacity or to higher prices for it (or perhaps both). There are simply no other realistic alternatives.

A good number of our foreign reinsurers might simply decide to stop reinsuring the U.S. nuclear pools and sell their capacity where taxes are not a problem. If enough of them did that, we could not continue to provide the current level of protection that nuclear reactor operators must have by law to protect the public. Please understand that the member insurance companies in our pools cannot simply take on more risk; they must limit their exposure to nuclear or any other potentially catastrophic risk to a prudent level.

If our capacity were to be significantly reduced because a number of our foreign reinsurers desert us, we might be able to find other qualified reinsurers, but we would have to pay an even higher price to attract them. We would have to pass that increase on to our customers, the nuclear utilities. They, in turn, would have to pass those increased costs on to their customers, the American consumers who are the electric ratepayers. That could include virtually anyone who uses electric power since in many cases no one can say whether any given kilowatt of electricity comes from a nuclear plant or a non-nuclear plant.

Proponents of this increase argue that it would raise revenue painlessly; the tax would be paid by foreign reinsurers. Some also say that it would benefit U.S. reinsurers by "leveling the playing field" with foreign reinsurers and therefore bring back business they may have lost to overseas competitors.

There is an ongoing debate regarding how much tax revenue might be produced, and whether the playing field is or is not level. I did not come to engage in that debate. My goal is to focus attention on two points; one, the fact that this tax increase would not be painless to U.S. consumers; they would wind up paying for it in their electric bills; and two, there is some reinsurance business, such as nuclear, that this supposed tax advantage could not bring back from overseas, because we already use all available U.S. capacity that meets our standards.

It has been suggested that foreign reinsurers in countries that have tax treaties with the U.S. can avoid the FET by simply obtaining **"closing agreements"** with the IRS. While a few of our larger foreign reinsurers have negotiated closing agreements, they did so as part of their **overall business plans** involving other lines of U.S. business, of which nuclear is just a small part. Most of our hundreds of overseas reinsurers are reluctant to go through the complex process necessary to obtain a closing agreement, particularly if nuclear reinsurance is the **only** business (or most of the business) they do in the U.S. They can simply take their capacity and reinsure business from other countries with less trouble and expense. (Not one of our 72 Spanish reinsurers has a closing agreement; only 5 of 65 German ones do; 1 of the 22 Finnish reinsurers does.) And, of course, many of our reinsurers are in countries that do not have tax treaties with the U.S.

In closing, let me say that when this tax proposal came up in Congress last year, as it has in several prior years, **it was again rejected.** From the perspective of the U.S. nuclear insurance pools, this tax increase could **undermine our ability to provide adequate insurance to our customers**, the electric utilities, so they can comply with the financial protection requirements of Price-Anderson and the NRC. It could either reduce the availability of foreign reinsurance, which we must have because U.S. capacity is insufficient, or increase its cost, or both. Either way, U.S. **consumers, and not foreign reinsurers, would bear the burden.**

Thank you, Mr. Chairman and Members of the Subcommittee, for the opportunity to share the views of ANI, MAELU and MAERP Reinsurance Association on this important subject.

I would be glad to answer any questions you may have.

Mr. NEAL. It seems that we are going to be captive to some procedural delays on the House floor and what I am going to do is run over and vote and I will come right back. I have a couple of questions for you. I know some of you were hoping you might be saved by the bell, but we do have just a couple of questions. I will be right back.

[Recess.]

Mr. NEAL. Thank you for that indulgence. Perhaps we can reconvene here.

Mr. McCloskey, at a previous hearing before this subcommittee in June you testified in favor of various revenue losing proposals. Today you have testified in opposition to a number of revenue raising proposals.

Can you suggest other means to offset the cost of the proposals that you have endorsed in your previous testimony?

Mr. MCCLOSKEY. Well, I guess tax the other fellow. I am only joking. My personal view, inasmuch as we do not have an association position is that I favor a value-added tax.

Mr. NEAL. Pretty candid, we appreciate that.

Mr. Singley, what impact has the current uncertainty over the proper tax treatment of environmental cleanup costs had on your members' efforts to plan ahead for these costs? If current IRS ruling position requiring capitalization is maintained, what impact do you think this will have on your members?

Mr. SINGLEY. Sir, is your question about the impact of the uncertainty or whether the IRS position will——

Mr. NEAL. If you could give us kind of a snapshot of both, that would be appropriate.

Mr. SINGLEY. Well, speaking as a tax professional, it is a traditional thing that as volume of any expenditures increase, they come under scrutiny by the revenue authorities when they may not have in the past. I think that is just what you expect. And normally the agency's actions are not to continue expense treatment, they usually come at you proposing that something should be capitalized.

There is a lot of concern about the proposal—about the analysis that these expenses should be capitalized. The problem in discussing it in general is that there is a—there is a very large number of fact patterns which I think is why you hear so much recommendation from various spokesmen. I think even the Treasury said they are studying it.

It is very difficult to make some succinct statement about how things ought to be treated. I think, in general, what most of the members of our industry are doing is analyzing these increasing expenditures in a more or less traditional capital versus expense way.

If I am investing in a piece of equipment, an incinerator at a remediation site, then that would tend to get capitalized like other items of capital equipment. If I have—if I am cleaning up something that is in the nature of a repair, then it tends to get expensed.

And I think, as I said, whenever you know someone is reviewing the issue, yes, you are concerned about it. But if your question is directed to at this time is it causing any change in industry patterns on these—on response to these sort of things, I think the answer to that is no.

There is a very strong—there is a very strong feeling, almost moral overtones to this. I mean, when some—when a problem develops, people—most companies go and try to do the right thing first and sort out details later. I think that probably, candidly, that is what most companies' response to this is.

Mr. NEAL. Thank you, Mr. Singley. We will let Mr. Gentile and Mr. Jarratt and Mr. Rahn have a crack at the next question.

In its 1990 report, the Treasury Department concluded that current law provides a competitive advantage for foreign reinsurance companies in tax havens. Do you disagree with this conclusion and can you recommend another approach to address this concern?

Mr. Gentile, would you like to go first and then we will have Mr. Jarratt or Mr. Rahn.

Mr. GENTILE. That would be fine. The ultimate parent of the corporation I work for is Swiss Reinsurance Company in Zurich, Switzerland. SwissRe is the second largest reinsurer in the world. SwissRe has a tax treaty with the United States which in effect does not contain an excise tax waiver.

If the current provision was enacted, there is considerable question as to whether or not an increase in excise tax from 1 to 4 percent would be applicable to transactions with SwissRe located in Switzerland. So one of the unintended effects of the increase in excise tax would be to tax premiums flowing from the United States to Switzerland which in fact has a relatively high tax rate but on a basis significantly different than the tax system in the United States.

Mr. NEAL. Mr. Kies.

Mr. KIES. I would just add one other thing, Mr. Chairman. The Treasury report actually concluded that if the existing 1 percent tax was waived, that it would give a competitive advantage to companies operating in tax havens but I don't believe it actually concluded that the 1 percent tax was inadequate to address competitive problems, and in fact, sometimes the 1 percent tax could actually result in a competitive disadvantage because the 1 percent tax applies even if the company makes no profit.

You could have a U.S. company that didn't make a profit, it would pay no income tax, but a company in a tax haven that lost money would still pay the 1 percent excise tax because it is paid on gross premiums, not on net income. So I think the Treasury report actually didn't come out and say that the 1 percent was inadequate to address competitive problems. It said, if you eliminated the 1 percent and waived it, that that could create competitive problems.

Mr. NEAL. Thank you for that clarification, Mr. Kies.

Mr. Gentile, you want to add anything else?

Mr. GENTILE. Yes. The only thing I would add is that is precisely the position that many foreign reinsurers find themselves in today, in fact having lost a significant amount of dollars because of Hurricane Andrew and other catastrophic losses, they find themselves paying a current 1 percent excise tax on a business where the bottom line is they lose money.

Mr. NEAL. Mr. Jarratt.

Mr. JARRATT. The only thing I could add to that is again the difficulty of trying to keep up with—where the reinsurance premiums go and the difficulty in trying to determine whether they are foreign or domestic and that the cost of the reinsurance is just unavailable at the present time.

Mr. NEAL. Mr. Rahn.

Mr. RAHN. Our concern is simply getting high quality reinsurance. We are not interested in tax havens in the sense that tax havens is a pejorative term in some circles. We are searching the globe for companies that have good, stable reputations and we find them in major nations all around the world. And beyond that, I cannot elaborate.

Mr. NEAL. Thank you. Thank you, gentlemen, for your testimony and now the real Mr. Chairman will take over.

Chairman RANGEL [presiding]. I may have some questions that I will be sending because I didn't have the opportunity to read your testimony or hear it. Thank you very much.

Chairman RANGEL. The next panel, panel three, Robert Green, vice president of tax policy for the National Foreign Trade Council and the former chief economist with the Joint Committee on Taxation, Peter Merrill, who is a partner with Price Waterhouse National Tax Services. Here representing U.S. Multinational Corporation Tax Policy Coalition is Tim Anson, senior manager, Price Waterhouse National Tax Services, and Raymond Wiacek, partner, Jones, Day, Reavis & Pogue, here in Washington for Emergency Committee for American Trade; and John Allis from Houston, Tex., a CPA.

We thank all of you. Your written testimony, without objection, will be entered into the record.

We will start off with Mr. McCloskey of the electronic—no, we won't. We will start off with Mr. Green from the National Foreign Trade Council.

STATEMENT OF ROBERT H. GREEN, VICE PRESIDENT, TAX POLICY, NATIONAL FOREIGN TRADE COUNCIL, INC.

Mr. GREEN. Thank you very much. Mr. Chairman and members of the subcommittee, my name is Bob Green, vice president for tax policy of the National Foreign Trade Council. We are pleased to have the opportunity to present our views on various miscellaneous tax proposals of interest to our membership.

NFTC is a trade association with 500 members, most of which are U.S. companies that are engaged in all aspects of international business trade and investment. Our focus is to promote policies that expand U.S. exports and enhance the ability of our companies to compete abroad.

For that reason, our testimony as well as our written statement will concentrate on certain proposals that affect the taxation of international transactions.

NFTC has consistently urged that a comprehensive review be undertaken of the international provisions of our current tax system. It is a widely accepted fact that the international tax rules in the United States have become exceptionally complex and administratively burdensome.

Unfortunately, proposals in the international area that are the subject of this hearing represent a further piecemeal approach to U.S. international tax policy. However, unlike previous proposals which were harmful in their impact, the proposal to convert the foreign tax credit into a deduction and the proposed repeal of the exemption for portfolio interest trade to foreign investors would cause irreparable injury to U.S. interests abroad.

The NFTC must express its strong opposition to these two proposals and to a third proposal to modify the rules for determining the source of income from export sales of inventory property. The proposed repeal of the election to treat foreign income taxes as paid as a credit instead of a deduction would compound the disadvantage our companies encounter when they are competing against multinational companies from other countries.

In 1991, a report that was prepared by Price Waterhouse found that U.S. companies already face a significantly higher effective tax rate on foreign income than a similarly situated company from Canada, France, Germany, Japan, the Netherlands or the U.K. A separate report of the GAO estimated that the effective corporate rate on worldwide income of U.S. companies was 37.1 percent for 1989.

The GAO noted that one of the most important disincentives to foreign investment by U.S. companies is the potential for double taxation that is inherent in the various limitations on the credit and other special rules that impose a U.S. tax on foreign-source income that has already borne a tax in excess of the U.S. rate. However, these limitations to which the NFTC takes strong exception, pale by comparison to the enormous tax increase that U.S. multinational companies would experience if the election to credit the foreign income taxes paid were converted into a deduction only. It is estimated that converting the foreign tax credit into a deduction could cause the overall tax burden on foreign-source income for U.S. companies to rise as high as 70 percent in some cases. It would be absolutely impossible for U.S. companies to compete abroad against their foreign counterparts with an overall tax burden at that level.

The NFTC strongly opposes also the proposal to remove the present law exemption for portfolio interest received by foreign investors from U.S. sources.

First, repeal of the exemption would discourage the flow into the United States of foreign capital on which the economy depends. It is a widely held view that the influx of foreign capital and the purchase by foreign investors of U.S. debt has had the effect of restraining interest rates in spite of soaring Federal budget deficits during the past decade.

If the United States repeals its exemption, funds currently held in U.S. debt instruments will simply be transferred to debt instruments in other countries that do not impose a tax on its interest. The inevitable consequence of this scenario would be to raise interest rates for both governmental and private purposes, thereby negating any short-term revenue gain to the United States.

Second, passage of legislation to repeal the exemption would materially violate the terms of numerous treaty obligations that the United States has with its allies, unless the legislation expressly provided that repeal of the exemption did not interfere with existing U.S. treaties.

And finally, repeal of the exemption would provide a return to treaty shopping in which foreign taxpayers would borrow funds for U.S. investment from tax haven countries. NFTC also opposes the two changes to the export source rule that were contained in H.R. 5270. These changes would allocate more income to U.S. source and thereby reduce the amount of the credit to U.S. exporters.

Since the only constant growth factor in the U.S. economy in recent history has been the growth of U.S. export sales, the NFTC opposes changes that would increase the cost of sales by U.S. exporters, which these proposals would certainly do.

It is clear that the impact of U.S. exports on our economy is substantial. As a percent of GNP, corporate profits from domestic sources dropped by more than 50 percent from the 1950s to the 1980s while the profits from foreign sources increased by 50 percent.

Moreover, employment related to export production tends to be high paying jobs. The average compensation for persons engaged in export production in 1986 was 30,100 while the average was 26,300 for the entire economy.

Third, a recent study concludes that tax benefits derived from the current export source rule are cost-effective in producing additional export sales. Finally, the proposals would increase the administrative burden for U.S. companies. Our companies simply do not possess the data necessary to reflect the profit for the CFCs.

We also would urge support for the foreign simplification measures that were introduced 2 years ago by Chairman Rostenkowski and for a proposal to extend the foreign tax credit carryover from 5 to 15 years.

Thank you, Mr. Chairman, for our opportunity to testify on these important measures.

Chairman RANGEL. Thank you, Mr. Green.

[The prepared statement follows:]

STATEMENT OF
THE NATIONAL FOREIGN TRADE COUNCIL, INC.
PRESENTED TO THE HOUSE WAYS AND MEANS SUBCOMMITTEE ON SELECT REVENUE MEASURES

Mr. Chairman and Members of the Committee:

The National Foreign Trade Council, Inc. (NFTC) is pleased to present its views regarding certain revenue proposals on which hearings are being held by the Ways and Means Subcommittee on Select Revenue Measures.

The NFTC is a trade association with some 500 members, founded in 1914. Its membership consists primarily of U.S. corporations engaged in all aspects of international business, trade, and investment. The primary focus of the NFTC is to encourage policies that will expand U.S. exports and enhance the competitiveness of U.S. companies by eliminating major tax inequities in the treatment of U.S. companies operating abroad. For that reason, our testimony and written statement will concentrate on certain proposals affecting the taxation of international transactions.

By way of historical perspective, the NFTC testified in 1992 on H.R. 5270 and earlier this year on the President's deficit reduction plan urging that a comprehensive review be undertaken of the international provisions in our current tax system. It is a widely accepted fact that the international tax rules in the U.S. have become exceptionally complex, administratively burdensome, and have made it more difficult for U.S. companies to compete in the U.S. and abroad. The process for reform of the international tax rules was given a major boost last year when Chairman Rostenkowski and then Congressman Gradison introduced H.R. 5270, the Foreign Income Tax Rationalization and Simplification Act of 1982. While we recommended certain changes to H.R. 5270 in our testimony before this Committee last year, we strongly urged that the process of comprehensive reform of the international tax regime continue. We also note that the Treasury study released earlier this year recommended that a comprehensive review be undertaken of the U.S. system for taxing international income.

Unfortunately, the proposals in the international area that are the subject of this hearing represent a further series of piecemeal modifications to U.S. international tax policy. However, unlike previous proposals which were harmful but not lethal in their impact, the proposal to convert the foreign tax credit into a deduction and the proposed repeal of the exemption for portfolio interest paid to foreign investors would wreak irreparable injury to U.S. interests abroad.

Specifically, the NFTC must express its strong opposition to three proposals in the foreign area that are the subject of this hearing: first, the proposal to repeal the current election to treat foreign income taxes as a credit and instead to allow only a deduction for income taxes paid; second, the proposal to repeal the exemption from withholding for portfolio interest paid to foreign investors; and third, a proposal to modify the rules for determining the source of income from export sales of inventory property.

1. REPEAL OF THE ELECTION TO TREAT FOREIGN INCOME TAXES PAID AS A CREDIT WOULD FURTHER UNDERMINE THE INTERNATIONAL COMPETITIVENESS OF U.S. COMPANIES CONDUCTING BUSINESS ABROAD.

The proposed repeal of the election to treat foreign income taxes paid as a credit instead of a deduction would cause a massive tax increase for U.S. multinational companies and would exacerbate the disadvantage that U.S. companies face in competing against companies from other countries.

Numerous studies have shown that U.S. companies operating abroad through foreign subsidiaries are taxed at a higher rate than are foreign multinationals with which they are competing. A 1991 report prepared by Price Waterhouse for the National Chamber Foundation found that U.S. companies already face "a significantly higher effective tax rate on foreign income than would a similarly situated multinational company from Canada, France, Germany, Japan the Netherlands or the UK." (U.S. International Tax Policy for a Global Economy, April 15, 1991).

Similarly, the U.S. General Accounting Office estimated that the effective corporate tax rate on the worldwide income of U.S. multinational corporations was 37.1 percent for 1989. The higher rate of tax on the foreign income of U.S. companies is attributable to a number of factors including: a higher corporate tax rate in many developed countries; restrictive interest allocation rules that contribute to excess foreign tax credits and a disallowance of interest expense allocated to foreign jurisdictions; numerous foreign tax credit limitation baskets; and recent changes to the R&E allocation rules that alter the apportionment of R&E expense away from the country of performance/i.e./the U.S. In the same GAO report, it was noted:

> "One of the most important disincentives to foreign investments by U.S. companies is the potential for double taxation inherent in the myriad foreign tax credit limitations and other special rules that can operate to impose U.S. tax on foreign source income that already has borne a foreign tax in excess of the U.S. rate."

However, these limitations, to which the NFTC takes strong exception, pale by comparison to the enormous tax increase that U.S. multinational companies would experience if the election to credit foreign income taxes paid under Section 901 were converted into a deduction only. It is estimated that converting the foreign tax credit into a deduction could cause the overall tax burden on foreign source income for U.S. companies to rise to 70 percent in some cases.

For these reasons and those that follow, the NFTC believes that disallowance of the foreign tax credit would represent an extraordinarily ill-advised reversal of U.S. tax policy and would further erode the competitive position of U.S. companies operating abroad:

a. Repeal of the foreign tax credit would subject the foreign source income of U.S. companies to double taxation. The foreign tax credit, now codified largely in Sections 901-908 of the Code, was designed primarily to avoid double taxation on the foreign income of U.S. persons, who, under our system, are taxed on their worldwide income. The credit prevents double taxation of foreign income by reducing the U.S. tax on such income by the amount of income taxes paid to foreign governments (not to exceed the maximum U.S. corporate rate). On the other hand, if the foreign income tax is less than the U.S. rate, the difference between the foreign and U.S. tax is payable to the U.S. The legislative history surrounding enactment of Section 901 supports the view that avoidance of double taxation on the worldwide income of U.S residents and citizens was the primary purpose underlying the foreign tax credit.

In general, the foreign tax credit attempts to achieve for the U.S. system of worldwide taxation a modified form of territorial taxation, under which citizens or residents are only taxed on income from sources within their boundaries. Repeal of the credit would subject U.S. companies conducting business abroad to double taxation, while their foreign competitors in other countries, in which the territorial system of taxation prevails, would only be subject to one level of taxation.

As former Assistant Secretary of the Treasury Stanley Surrey once observed, the foreign tax credit should remain the centerpiece of U.S. international tax policy. In his testimony before the Senate Relations Committee in 1967 regarding the U.S. tax Convention with Brazil, then Assistant Secretary Surrey stated:

"American investment would not proceed at all without the foreign tax credit because then, as the Chairman pointed out, two taxes would be imposed and the overall burden of two taxes would be so great that international investment would practically cease."

As Chairman of the House Task Force on Foreign Income in 1976, Chairman Rostenkowski reaffirmed this rationale for the foreign tax credit:

"I am firm in my belief that the foreign tax credit is the key to U.S. international tax policy, and should, under no circumstances, be repealed or modified in any fundamental way. I say this simply because it seems to me that if foreign governments tax the foreign income of U.S. multinational corporations, and then the U.S. taxes that income in addition, double taxation results. The tax burden of this double taxation cannot help but impede international trade and international movement of capital. For this reason, as one who strongly believes in expanding international trade and unrestricted capital movement, I can see no circumstances under which I would recommend any fundamental change in the foreign tax credit."

b. Comparisons between income taxes paid to foreign governments and similar taxes paid to state governments are inappropriate. One of the purported justifications for disallowance of the foreign tax credit is the assertion that foreign income taxes should not be granted more favorable treatment under our tax system than is accorded the payment of taxes to state and local governments. Payments of state and local income taxes are deductible, not creditable, under our federal income tax laws.

The NFTC believes that this comparison is based on a faulty premise. In our judgment, taxation should be treated as a price to be paid for the services and benefits of government. In the case of a business operating in a given state, it is entirely appropriate for that state to tax the income of the business derived within its boundaries. However, an American enterprise conducting business abroad should not have to pay tax to the U.S. Treasury for these benefits to the same degree as if the business activity were being conducted in the United States.

2. THE EXEMPTION FROM WITHHOLDING FOR PORTFOLIO INTEREST PAID TO FOREIGN INVESTORS SHOULD BE RETAINED. For the following reasons, the NFTC strongly opposes the proposal to remove the present law exemption found in Sections 871(h) and 881(c) for portfolio interest from U.S. sources received by foreign investors.

a. Repeal of the exemption would discourage the flow into this country of foreign capital on which the U.S. economy so heavily depends. It is a widely accepted fact among economists that the influx of foreign capital and the purchase by foreign investors of U.S. debt in substantial amounts has had the salutary effect of restraining interest rates even though the federal budget deficit has soared during the past decade. It is also clear that the exemption from tax for portfolio interest has contributed materially to the ability of the U.S. economy to attract foreign capital that the government and private sector so desperately need.

b. Repeal of the exemption would cause U.S. interest rates to rise. Since the exemption for portfolio interest received by foreign taxpayers has contributed to the influx of foreign capital, repeal of the exemption conversely would cause a massive exodus of foreign ownership of U.S. debt instruments. Because money is fungible in the international marketplace, it seeks the highest yield available. Most nations provide an exemption from tax for interest paid to foreign investors. If the U.S. repealed its exemption for portfolio interest paid to foreign investors, funds currently held in U.S. debt instruments would simply be transferred to debt instruments in other countries that do not impose a tax on interest. The inevitable consequence of this scenario would be to raise interest rates for both governmental and private purposes in the U.S., due to the diminished pool of resources available for lending. Any short-term revenue gain that might be derived from a repeal of the exemption for portfolio interest paid to foreign investors would be more than offset by higher interest costs to the Federal government in financing its deficit and to the private sector in the form of higher borrowing costs.

c. Repeal of the exemption for portfolio interest would constitute a material breach of U.S. treaty obligations. Passage of legislation to repeal the exemption for portfolio interest paid to foreign investors would materially violate the terms of numerous treaties that the U.S. has with its allies, unless such legislation expressly provided that repeal of the exemption did not interfere with existing U.S. treaty obligations. Otherwise, repeal of the exemption provided foreign taxpayers for portfolio interest received under Sections 871(h) and 881(c) automatically would cause the general withholding rate of 30% of gross income to apply under Sections 871(a) and 881 to interest paid to foreign taxpayers. Since most U.S. treaties provide for either an exemption or a nominal rate of withholding on interest paid to residents of treaty partners, the imposition of a 30% withholding rate on gross interest clearly would constitute a material breach of existing U.S. treaty obligations. (U.K. (Art.XI), etc.) Moreover, if the intent of the repeal were to override U.S. treaty obligations, such action would be in direct conflict with the U.S. model treaty, which exempts virtually all interest from tax, not just portfolio interest. (U.S. Model Treaty, Article II(1)).

On the other hand, if the Congressional intent behind a proposed repeal of the exemption were not to override U.S. treaty obligations, then the impact of the repeal is largely negated. Countries without tax treaties with the U.S. would immediately initiate treaty negotiations to reduce the tax burden on the U.S. source interest income of its residents.

d. Repeal of the exemption would invite a return to treaty shopping. One of the primary reasons for passage of the exemption for portfolio interest received by foreign taxpayers under Sections 871(h) and 881(c) was the acknowledgement by both the U.S. Treasury and the Congress that imposition of high withholding rates on interest only caused foreign taxpayers to borrow through tax haven countries, which had tax treaties that provided for little or no tax on interest paid from the U.S. The legislative history underlying passage of the Deficit Reduction Act of 1984 is replete with examples of taxpayers seeking refuge under treaty provisions with countries, such as the Netherlands Antilles, that did not impose withholding on U.S. source interest. Repeal of the current exemption for portfolio interest paid to foreign taxpayers would trigger a return to the period prior to passage of the 1984 tax bill that saw taxpayers engage in treaty shopping on a widespread basis.

3. SOURCE OF INCOME FROM EXPORT SALES OF INVENTORY PROPERTY. H.R. 5270, introduced by Chairman Rostenkowski and then Congressman Gradison, proposed two changes that would reallocate more income to domestic source from certain export sales of inventory property. One provision would allocate more income to U.S. source by applying the production/marketing split to the combined income of the U.S. producer/taxpayer and the foreign/related purchaser. The second provision would treat as U.S. source income the gain derived from the sale abroad to a CFC if the ultimate consumption of the property occurs in the U.S., and the sale is not attributable to an office or fixed place of business of the U.S. producer outside the U.S.

For the following reasons, the NFTC opposes these proposed changes to the export source rule contained in Section 863(b):

a. The proposals would increase the costs of U.S. export sales, which tend to produce high paying jobs and represent a growth factor in the U.S. economy. Taken as a whole, the new proposals would increase the costs for U.S. companies that export their products. The consequence could be to restrain one of the few areas of growth in the U.S. economy, namely, export sales, and to reduce employment attributable to the production and marketing of products for export.

Recent data support the statement that export sales materially contribute to the growth of the U.S. economy. As a percent of GNP, corporate profits from domestic sources dropped by more than 50 percent from the 1950's to the 1980's (from 10 to 5 percent), while profits from foreign sources increased by 50 percent (from 0.6 to 0.9 percent). (See U.S. International Tax Policy for a Global Economy, p.33). Exports of goods and services contributed roughly 12 percent of U.S. GNP in 1990 (Survey of Current Business 71, p.6).

Moreover, employment related to export production tends to be high paying jobs. The average compensation for persons engaged in export production in 1986 was $30,100.00, while the average was $26,300.00 for the entire economy (Statistical Abstract of the United States, Tables 665 and 1310). Moreover, multinational firms continue to produce over 60 percent of U.S. merchandise exports (Statistical Abstract of the United States, Table 1.5).

b. Higher taxes on foreign source income of U.S. companies could decrease U.S. employment. The implicit rationale for proposals to allocate a higher percentage of export sales income to U.S. source is the desire to preserve U.S. employment. However, recent evidence suggests that attempts to impose higher taxes on the foreign source income of U.S. multinational companies is misguided. Any decline in the competitiveness of U.S. multinational companies could decrease domestic employment. (See Bergsten, Horst, and Moran, American Multinationals and American Interests, pp. 101-104).

More recently, the 1991 Economic Report of the President rejected the argument that the foreign production of U.S. multinational companies comes at the expense of domestic employment. (p. 259) The general view seems to be that production abroad by CFCs tends to complement U.S. production, not to supplant jobs associated with domestic production.

c. Any tax benefits derived from the current export source rule is cost effective in producing additional export sales by U.S. companies. An analysis of recent data includes the statement that any tax benefits derived by U.S. multinational companies from the current 50-50 rule is cost effective in generating export sales beyond those that would otherwise be produced.

According to Gary Hufbauer, the implied boost to U.S. exports from the 50-50 method was between 12.9 billion and 19.0 billion in 1990. These figures compare favorably with the revenue costs attributable to the 50-50 method in fiscal year 1990 of 2.6 billion and 3.2 billion for 1992 respectively. (See U.S. Taxation of International Income, p. 127).

d. The proposals would be administratively burdensome and would undermine compliance. Many NFTC member companies believe that the proposals would raise serious compliance concerns by imposing additional administrative recordkeeping requirements. The proposals would mandate that profits be segregated between the U.S. producer and the CFC, which in many cases is not feasible. Many U.S. companies do not possess the data necessary to reflect the profits on resale by the CFCs. If U.S. companies were unable to accurately ascertain the apportionment of profit between the U.S. company and the foreign affiliate, then compliance would suffer with the likelihood that litigation would increase. The two proposals clearly run contrary to the stated intent of both H.R. 5270 and the recent Treasury study that the U.S. international tax regime is unduly complex and requires simplification.

The NFTC also wishes to express its support for several important measures relating to the taxation of international income that could improve compliance, reduce complexity, and enhance the competitiveness of U.S. companies operating abroad.

The first two proposals were the subject of hearings by this Subcommittee on June 24. One such proposal, for which the NFTC has already expressed its strong support, is the proposal to extend the carryover period for excess foreign tax credits from the present 5 years to 15 years. The reasons for our endorsement of this measure stem primarily from our desire to avoid double taxation on economic income derived from multinational transactions. We also support the proposal to raise the reporting threshold in Section 6046 to 10 percent, instead of the present 5 percent, of the value of stock ownership in a foreign corporation. This proposal would improve the administration of the tax laws with no corresponding revenue loss to the Treasury.

In addition to the proposals discussed above, the NFTC urges the Congress to adopt several measures contained in the foreign simplification package introduced last year by Chairman Rostenkowski and subsequently approved by the Congress, although the legislation of which it was a part was not enacted.

These measures include: extending the application of the indirect foreign tax credit under Section 902 and 960 to sixth tier CFCs; simplification of the translation of foreign taxes into U.S. dollars; harmonization of the rules that exist under present law between the PFIC and the Subpart F rules. The NFTC believes that adoption of these proposals would greatly enhance compliance and simplify the administration of the tax laws relating to international transactions.

The NFTC appreciates the opportunity to submit its comments on the various tax proposals that are the subject of the Subcommittee's hearings.

Chairman RANGEL. Mr. Merrill.

STATEMENT OF PETER MERRILL, PARTNER, PRICE WATERHOUSE, NATIONAL TAX SERVICES ON BEHALF OF THE U.S. MULTINATIONAL CORPORATION TAX POLICY COALITION; ACCOMPANIED BY TIM ANSON, SENIOR MANAGER, PRICE WATERHOUSE, NATIONAL TAX SERVICES

Mr. MERRILL. Good morning. I am Peter Merrill. I am a partner in Price Waterhouse's international tax practice here in Washington. I appreciate the opportunity to appear before the subcommittee today on behalf of the U.S. Multinational Corporation Tax Policy Coalition. The coalition consists of more than 20 U.S. multinationals from a broad range of industries. A list of coalition members is attached to my written statement.

As the subcommittee reviews foreign tax proposals, it should recognize that the U.S. position in the global economy has changed dramatically. Three decades ago the United States was the world's largest lender of capital. Today we are the world's largest debtor nation. Three decades ago, 18 of the 20 largest U.S. corporations were among the world's largest corporations. Today only 9 U.S. corporations rank in the top 20.

In the 1960s tax policymakers felt little need to analyze how the tax system affected the competitiveness of U.S. companies. Today we can't afford to ignore global competition in formulating our Nation's tax policy.

In the new international economic environment, the subcommittee should avoid measures which discriminate against foreign-source income, are inconsistent with international norms, or that needlessly increase complexity. Last year the committee began a comprehensive review of the U.S. system of taxing international income.

Chairman Rostenkowski and former Representative Gradison introduced H.R. 5270 as a starting point. At that time, Chairman Rostenkowski stated and I quote, "I do not intend that any revenue offsets in the bill be used for deficit reduction or any purpose other than funding this bill."

Yet two of the foreign provisions before the subcommittee today have been cherry picked from H.R. 5270 in contravention of the chairman's intent.

I also would like to call the subcommittee's attention to a major study of international tax reform initiated by the Treasury Department in response to H.R. 5270. An interim report was released by the Treasury Department in January of this year.

As part of this study, Treasury economists have begun to improve their models to better understand the effects of U.S. tax policy in a global economy. Congress should have an opportunity to consider the results of the completed Treasury study before changing the international tax rules.

I would now like to briefly discuss three of the foreign tax proposals before the subcommittee today. That is the repeal of the foreign tax credit, changes in the export source rules, and the 30 percent withholding tax on portfolio interest. I note that Treasury in their testimony submitted this morning also opposed these three proposals.

First, the coalition strongly opposes repeal of the foreign tax credit. The deduction system for foreign taxes is not used by any other major industrial country and can result in much higher tax burdens on foreign income as compared to U.S. source income.

As shown on my written testimony, of the 24 member countries of the OECD, half utilize the foreign tax credit system like the United States, the other half simply exempt foreign dividends. No country uses a deduction system which is the proposal before this subcommittee today.

I would also like to point out that repeal of the foreign tax credit would override U.S. tax treaty obligations and could result in a loss of tax benefits granted to U.S. persons under these treaties.

Second, I would like to discuss the proposed modifications to the export source rules. One of the export source rules is designed to divide the income of exporters between production and marketing activities. Under present law, a U.S. exporter divides its income based on a 50/50 split.

The proposal would require that the 50/50 split be applied to the combined income of the exporter and a related foreign subsidiary. While this would achieve branch subsidiary conformity, which apparently is the goal, the coalition fails to discern any tax policy rationale for including a foreign subsidiary's income in a calculation that is designed to split the U.S. exporter's income between production and marketing.

Last year, Treasury testified that they thought the reason for this provision was transfer pricing abuse. We agree with Treasury's testimony last year that the transfer pricing rules that were put out last year and put out this year in temporary form are adequate to handle this alleged problem. The coalition also opposes these proposed changes as did Treasury this morning because of the high compliance cost to U.S. exporters.

Finally, the coalition is concerned that this proposal taken from H.R. 5270 is being considered outside the context of international tax reform.

Finally, before the subcommittee is a proposal to reinstate the 30 percent withholding tax on portfolio interest. The coalition opposes this proposal.

By way of background, this committee repealed in 1984 the 30 percent withholding tax to allow U.S. companies access into the Eurobond market. On my written statement, you will see that since repeal of the 30 percent withholding tax, U.S. corporate debt borrowed from abroad has increased tenfold.

Reinstatement of the withholding tax would terminate the ability of U.S. corporations to access the Eurobond market. This would be true not only for corporate debt but U.S. Government securities also would be in the same position. The effect on interest rates would be discernible immediately; in fact, based on a wire service report on Thursday, September 9, that Congress was simply considering this proposal interest rates went up. In response, the Treasury Department the very next day announced that they opposed this proposal.

In conclusion, I would like to thank the subcommittee for the opportunity to testify. I urge the subcommittee to refrain from piecemeal changes in the Nation's international tax regime. Such changes will have unintended effects and increase complexity.

Thank you.

Chairman RANGEL. Mr. Anson.

Mr. MERRILL. He is with Price Waterhouse.

[The prepared statement follows:]

TESTIMONY OF PETER MERRILL, PRICE WATERHOUSE
ON BEHALF OF
THE U.S. MULTINATIONAL CORPORATION TAX POLICY COALITION

Introduction

I am Peter Merrill and I am an international tax practice partner in Price Waterhouse's Washington National Tax Service office here in Washington, D.C. I appreciate the opportunity to appear before the Subcommittee today to discuss the foreign tax provisions that are a part of the miscellaneous revenue raising proposals before the Subcommittee. I am testifying on behalf of a broad-based coalition of U.S. multinationals including manufacturing, natural resource, and financial service companies (see attached list of coalition members).

The Subcommittee's August 18, 1993 press release announcing these hearings contains five specific proposals under the caption "foreign tax provisions." The first part of this testimony discusses the importance of U.S. international tax policy and our view that any substantive changes in this area should be considered carefully in the context of our international tax rules as a whole and the global economy in which U.S. companies compete.

The second part of this testimony specifically addresses three of the foreign tax provisions before the Subcommittee: (1) repeal of the foreign tax credit; (2) modification of the export-source rules; and (3) reinstatement of 30-percent withholding on portfolio interest. In short, the coalition strongly opposes each of these proposals.

General Comments on U.S. International Tax Policy

As the Subcommittee reviews changes in U.S. international tax policy, it is important to recognize that the U.S. position in the global economy has changed dramatically over the last three decades.

Global economy

Three decades ago, U.S. corporations accounted for over half of all multinational investment in the world, our nation produced about 40 percent of world output, and we were the world's largest lender of capital. U.S. corporations now account for less than one-third of multinational investment, the U.S. economy produces less than 30 percent of world output, and we are the world's largest debtor. Three decades ago, 18 of the 20 largest corporations in the world were headquartered in the United States; today, only nine U.S. corporations rank in the top 20.

In the 1960's tax policy makers felt little need to analyze how the tax system affected the competitiveness of U.S. companies in world markets. Today, the U.S. economy is no longer so dominant that we can afford to ignore global competition in formulating our nation's tax policy.

Comparison of countries' foreign tax rules

In 1991, Price Waterhouse completed a study, *U.S. International Tax Policy for a Global Economy*, which used case study examples to compare U.S. rules for taxing foreign-source income with those of other major industrial countries. The examples compare the effective tax rate that results when the same operations are conducted by foreign affiliates of parent corporations based in the United States, Canada, France, Germany, Japan, the Netherlands, and the United Kingdom. The facts in the examples are based on the average characteristics of U.S. corporations engaged in manufacturing and trade as reported by the IRS.

In these examples, the U.S. multinational incurs a significantly higher effective tax rate on foreign income than would a similarly situated multinational headquartered in any of the six comparison countries. The U.S. multinational confronts an effective tax rate of 35.2 percent as compared to an average effective tax rate of 29.2 percent in the six other countries.

The higher effective tax rate for U.S. companies results from several features of the U.S. system of taxing foreign source income that generally are not used in other countries, including: (1) the water's-edge fungibility approach to allocation of interest expense (under which a portion of U.S. interest expense of the affiliated group is treated as foreign source, but no amount of foreign interest expense is treated as U.S. source); and (2) the current taxation of income from foreign base company sales.

The Price Waterhouse report also noted that U.S. tax rules discourage participation by U.S. multinationals in foreign joint ventures that they do not control. The U.S. rule requiring a separate foreign tax credit limitation for dividends from each noncontrolled foreign corporation results in enormous complexity as well as a competitive disadvantage for U.S.-headquartered multinationals.

Implications for U.S. international tax policy

The new international economic environment and the relative unattractiveness -- from a tax perspective -- of the United States as a headquarter location for a multinational corporation have several important policy implications.

The Coalition firmly believes that revenue-raising measures in the international area should be considered carefully in the context of U.S. international tax rules as a whole, the systems used in other countries, and the compliance costs entailed. In particular, we urge the Subcommittee to avoid measures that (1) discriminate against foreign-source income; (2) are inconsistent with international norms; and (3) increase complexity.

Comprehensive review of U.S. international tax rules

A comprehensive review of the U.S. system of taxing international income was initiated last year with the introduction of H.R. 5270 (The Foreign Income Tax Rationalization and Simplification Act of 1992) by House Ways and Means Committee Chairman Dan Rostenkowski (D-IL) and former Rep. Bill Gradison (R-OH). In his statement of introduction, Chairman Rostenkowski declared:

> "I want to emphasize that I do not intend that the revenue offsets contained in the bill be used for deficit reduction or any purpose other than funding this bill."

Yet, two of the foreign provisions before the Subcommittee today have been "cherry-picked" from H.R. 5270 in contravention of Chairman Rostenkowski's original intent. The Coalition agrees with Chairman Rostenkowski that U.S. rules for taxing foreign source income should viewed comprehensively and that the revenue offsets in H.R. 5270 should not be used for unrelated purposes.

I also would like to call the Subcommittee's attention to a major study of international tax reform initiated by the Treasury Department in response to the introduction of H.R. 5270. An interim report was released by the Treasury Department in January of this year.[1] Treasury economists, as part of this study, have begun the process of improving their models to better understand the effects of U.S. policies in a global economy. Congress should have an opportunity to consider the results of the completed study before making major changes in the international tax rules.

The remainder of this testimony addresses three foreign tax provisions before the Subcommittee today: (1) repeal of the foreign tax credit; (2) modification of the export-source rules; and (3) reinstatement of 30-percent withholding on portfolio interest.

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[1] U.S. Department of the Treasury, *International Tax Reform: An Interim Report*, January 1993.

Repeal of the Foreign Tax Credit

Background

U.S.-based multinational corporations are taxed on their worldwide taxable income, *i.e.* income from both U.S. and foreign sources. Foreign income may be earned directly by a U.S. company through its foreign activities or indirectly as a dividend received from a foreign subsidiary. Foreign income generally is also subject to tax in the local foreign jurisdiction.

Since 1918, to avoid international double taxation of foreign income, U.S. residents have been allowed to claim a credit for foreign income taxes paid or deemed paid up to a limitation equal to the amount of U.S. tax (before credit) on foreign-source income. The foreign tax credit limitation is calculated for eight separate statutorily defined categories of income. Credits in excess of these limitations may be carried back two years and forward five years.

Under present law, taxpayers may deduct foreign taxes in lieu of the foreign tax credit. The generally disadvantageous alternative of deducting foreign taxes is used only when foreign taxes cannot be credited as a result of the foreign tax credit limitation and five-year carryforward period.

The foreign tax credit is one of two internationally accepted means for relief of international double taxation, the other being an exemption of certain foreign income generated from active business operations. Every major industrial country follows one of these two approaches; none taxes foreign source income without a credit for foreign taxes paid with respect to this income.

As shown in the following table, half of the 24 member countries of the Organization of Economic Cooperations and Development (OECD) generally exempt foreign-source dividends from treaty countries rather than, as in the United States, including the dividends in taxable income with a credit for foreign taxes associated with these dividends. These countries generally use a "modified" exemption system: exempting active foreign-source income while taxing passive income, usually on a current basis, as under U.S. rules.

The Burke-Hartke bills, introduced in 1971 and 1973, would have repealed the foreign tax credit, among other changes in the international tax rules. The foreign tax credit repeal was opposed by the Treasury Department and was not approved by either the House Committee on Ways and Means or the Senate Finance Committee.

Proposal

Under one of the proposals before the Subcommittee, the foreign tax credit would be repealed. The present law alternative to deduct foreign taxes would, as a consequence, be the only mechanism for partially mitigating double taxation of foreign-source income.

Discussion

The Coalition strongly opposes repeal of the foreign tax credit. A deduction system for foreign taxes is not used by any other major industrial country and would result in much higher total tax burdens on foreign as compared to U.S. source income.

Taxation of Foreign-Source Dividends in OECD Countries

[Tax law as of January 1, 1991; based on wholly-owned subsidiary]

Country	Treatment of foreign-source dividend from:	
	Treaty countries	Non-treaty countries
Australia	Exemption[1]	Worldwide credit
Austria	Exemption	Exemption
Belgium	Exemption of 90% of gross	Exemption of 90% of gross dividend
Canada	Exemption	Worldwide credit
Denmark[2]	Exemption	Credit by source/exemption
Finland	Exemption	Credit by source
France	Exemption of 95% of gross	Exemption of 95% of gross dividend
Germany	Exemption	Credit by source
Greece	Credit by source	Credit by source
Iceland	Worldwide credit	Worldwide credit
Ireland	Credit by source	Deduction
Italy	Credit by source	Credit by source[6]
Japan	Worldwide credit	Worldwide credit
Luxembourg	Exemption	Exemption
Netherlands	Exemption	Exemption
New Zealand	Credit by source	Credit by source
Norway	Credit by source	Deduction
Portugal	Credit by source	Deduction
Spain[3]	Credit by source	Credit by source
Sweden	Exemption	Credit by source
Switzerland[4]	Exemption	Exemption
Turkey	Credit by source	Credit by source
United Kingdom	Credit by source	Credit by source
United States[5]	Worldwide credit	Worldwide credit

[1] Only for treaty countries designated as having corporate tax systems similar to Australia's.

[2] Dividend from a foreign subsidiary (minimum 25% holding) in a country that has a corporate tax system similar to Denmark's. This also applies to non-treaty countries.

[3] Spain exempts dividends from Switzerland.

[4] Strictly, Switzerland does not have an exemption system; however, total dividends received from abroad are divided by total income, and this ratio is then used to reduce the Federal income tax. Similar reliefs are given in most cantons. Assuming that cantonal relief is precisely the same as Federal relief, the net effect is as if there were an exemption system.

[5] In the U.S., the credit is separately calculated for several categories of income.

[6] Exemption of 60% for parent companies.

Source: OECD, *Taxing Profits in a Global Economy: Domestic and International Issues*, pp. 63-64.

For a U.S. corporation operating abroad in a country that imposes income tax at the U.S. rate and has a 10-percent withholding tax on dividends remitted to U.S. shareholders, the total corporate income tax burden (U.S. and foreign combined) on foreign equity would increase by about 50 percent (from 41.5 to 62 percent under the proposal).[2] A 50-percent increase in the tax burden on foreign direct investment would virtually eliminate the ability of U.S. multinationals to operate competitively in countries that impose corporate income tax.

In the new global economic environment, international competitiveness requires foreign presence. Consequently, erecting tax barriers to prevent foreign investment would have adverse effects on the domestic economy. A large body of research indicates that U.S. exports and research expenditures are closely linked to foreign investment. Almost two-thirds of all U.S. exports are made through the foreign subsidiaries of U.S. multinationals, and empirical studies show that the industries with the largest amount of foreign investment are also the industries which are the most successful exporters. Foreign investment also allows U.S. companies to utilize innovation and know-how on a worldwide basis which increases the potential return from research expenditures. It is estimated that elimination of the ability of U.S. companies to invest abroad would reduce U.S. research expenditures by 12 to 15 percent.[3]

Some have argued that foreign investment should be prevented in order to increase domestic investment. This short-sighted view ignores the fact that most foreign investment is financed from foreign sources. On a net basis, income repatriated by U.S. multinationals has exceeded net U.S. foreign direct investment in every single year since 1960.[4]

Modification of Export Source Rules

Background

Under present law, when a U.S. manufacturer exports inventory it has produced in the United States, the income has a divided source -- income deemed related to production activities is U.S. source and income deemed related to sales activities is foreign source. Under Treasury regulations, income is divided under either the independent factory price (IFP) method or the so-called "50-50 method."

Under the IFP method, income related to production activities, and sourced in the United States, is determined based on the price that the exporter would charge on sales to independent distributors.

Under the 50-50 method, half of the gross income from export sales is sourced according to the title passage rule, i.e., the place where title passes, and the other half is apportioned on the basis of the location of the exporter's assets held or used to produce items sold. For most exporters, use of this method generally yields a nearly equal division of income between U.S. and foreign sources.

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[2] At a 35-percent foreign corporate income tax rate, $100 of foreign income would be subject to $35 of income tax, and a net dividend of $58.50 could be remitted after withholding $6.50 of tax (at an assumed 10-percent rate) on the $65 of after tax profits. Under present law, no U.S. tax would be due on the $58.50 dividend, so the total tax burden would be $41.50 ($35 of foreign income tax plus $6.50 of foreign withholding tax). By contrast, under the proposal, $20.48 (35 percent of $58.50 dividend) of U.S. income tax would be due, raising the combined tax burden to $61.98 ($41.50 of foreign tax plus $20.48 of U.S. tax).

[3] See, Price Waterhouse, *U.S. International Tax Policy for a Global Economy*, National Chamber Foundation, 1991.

[4] Emergency Committee for American Trade, *Mainstay II: A New Account of the Critical Role of U.S. Multinational Companies in the U.S. Economy*, July 1993, p. 16.

Proposal

Before the Subcommittee are two changes to the method by which income from the sale of inventory property is sourced. Both provisions are based on a proposal contained in H.R. 5270.

Under the first proposal, where an IFP does not exist and the exporter sells to a related foreign corporation, the amount of income treated as related to production activities and sourced to the United States could not be less than the amount determined under the 50-50 method treating the exporter and its foreign subsidiary as a single entity.

Under the second proposal, relating to domestic use of exported property, income related to the export of inventory property would be treated entirely as U.S. source if the buyer is a U.S. resident and (1) the property is used, consumed, or disposed of in the United States, and (2) the sale is not attributable to a foreign office of the exporter.

Discussion

Last year, Treasury testified that the first proposal is intended to prevent aggressive transfer pricing designed to increase foreign-source income for purposes of the foreign tax credit limitation.[5] The Coalition believes that the new intercompany pricing regulations released by the IRS on January 13, 1993 fully address any possible concerns in this regard.

Another rationale for the first proposal apparently is the view that present law provides different treatment of exports through foreign branches as compared to foreign subsidiaries. To address this perceived problem, the proposal would require that the 50-50 split be applied for each product to the combined imcome of a U.S. exporter and a related foreign subsidary that purchases the product. While this would treat sales through a subsidiary in the same manner as sales through a branch, the coalition fails to discern any tax policy rationale for including a foreign subsidiary's income in a calculation designed to divide the U.S. exporter's income between domestic and foreign sources.

The Coalition believes that the proposed remedy to this perceived problem would impose extremely high compliance costs on U.S. exporters. The proposed rule would require U.S. exporters and their foreign subsidiaries to develop records for reporting the profits associated with individual sales. Detailed combined taxable income calculations would be required at both the U.S. and the foreign affiliate levels. Such calculations would require allocation and apportionment of income and expenses for each export sold through a foreign affiliate. This information generally is not available in the financial or tax records of U.S. exporters or their affiliates and could not be produced without incurring significant costs.

The second proposal, relating to domestic use of exported property, addresses a situation that rarely is seen in practice. As in the case of the first proposal, the suggested remedy would be extremely burdensome to the IRS and taxpayers because it would be necessary to trace the ultimate disposition of property sold abroad.

In testimony before the Ways and Means Committee on the so-called "runaway plant" bill (H.R. 2889), which was introduced in 1991 by former Rep. Byron Dorgan (D-ND) and Rep. David Obey (D-WI), Treasury stated that the determination of whether property ultimately is imported into the United States imposes an enormous burden on the IRS:

> The ... task could prove insurmountable without the cooperation of all of the parties. Such cooperation from unrelated foreign customers with no financial or legal interest in cooperating, however, may be unlikely. The IRS may also have to trace sales through multiple unrelated foreign parties in several

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[5] Statement of Fred T. Goldberg, Jr., Assistant Secretary (Tax Policy), Department of the Treasury, before the Committee on Ways and Means, U.S. House of Representatives, July 21, 1992, p. 243, Serial 102-176.

> countries, including countries with which we have no tax treaty relationship and from which we cannot readily obtain information. The likelihood of obtaining accurate information and of being able to perform an audit in such a case is very low. If the transactions involve fungible property, such as minerals, agricultural products, or other commodities, the IRS would have no practical way to tell what was imported indirectly from a U.S. controlled foreign corporation and what was not. Further, where property produced by a U.S. controlled foreign corporation is substantially transformed by its purchaser, as, for example when bauxite mined by the controlled foreign corporation is used to make aluminum which is then imported into the United States, it is unclear whether the property that was transformed (the bauxite) should be considered imported property or not.[6]

Both proposed changes to the export source rules would increase costs for U.S. exporters, whether or not they ultimately would pay more tax. This would reduce the competitiveness of U.S. exports as compared to foreign-produced goods and would reduce the incentive to manufacture in the United States. Consequently, the proposals would tend to reduce U.S. exports and associated U.S. jobs.

Finally, the Coalition notes that both of the proposed changes in the sales source rules before this Subcommittee were contained in the Rostenkowski-Gradison bill (H.R. 5270). In view of Chairman Rostenkowski's statement last year, the Coalition believes it is inappropriate to consider these proposals as free-standing revenue raisers.

Reimposition of 30-Percent Withholding Tax on Portfolio Interest Paid to Foreign Persons

Background

Prior to the Deficit Reduction Act of 1984, the United States imposed a flat 30-percent tax (subject to reduction by U.S. tax treaties) on the gross amount of interest received by nonresident aliens and foreign corporations if not effectively connected with the conduct of a trade or business of the recipient within the United States. The tax generally was collected by means of withholding by the person making the payment to the foreign recipient.

In addition to a number of statutory exemptions, the withholding tax on portfolio interest was reduced or eliminated, prior to the 1984 Act, by various income tax treaties of the United States. The U.S. income tax treaty with the Netherlands, as extended to the Netherlands Antilles, generally exempted U.S. source interest paid to recipients in the Netherlands Antilles from withholding tax.

Prior to the 1984 Act, U.S. corporations raised substantial amounts of capital in the Eurobond market by issuing debt through Netherlands Antilles finance subsidiaries. The Netherlands Antilles did not impose any withholding tax on interest paid by resident finance subsidiaries. Because the Eurobond market is generally comprised of bonds not subject to withholding tax, an issuer of debt subject to a significant withholding tax would not be able to obtain competitive rates (inclusive of tax) in the Eurobond market.

In 1984, Congress eliminated the 30-percent withholding tax on certain portfolio interest to allow direct access to the Eurobond market without the necessity of using Netherlands Antilles finance subsidiaries.

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[6] Statement of Philip D. Morrison, International Tax Counsel, Department of the Treasury, before the Committee on Ways and Means, United States House of Representatives, October 3, 1991, pp. 23-24.

Proposal

Under H.R. 889, the 30-percent withholding tax on certain portfolio interest paid to foreign recipients would be reinstated.

Discussion

Reinstatement of the 30-percent withholding tax on portfolio interest would terminate the ability of U.S. corporations to access the Eurobond market on a direct and substantially tax-free basis because Netherlands Antilles finance subsidiaries are no longer viable as a result of treaty modifications and U.S. tax law developments. Such an action would be completely contrary to the stated rationale for repealing the 30-percent withholding tax in 1984:

> "Congress believed it important that U.S. businesses have access to the Eurobond market as a source of capital."[7]

Absent access to the Eurobond market, U.S. interest rates would rise. This would be true not only for corporate debt but for U.S. government securities as well. The effect on interest rates would be discernible immediately. In fact, based merely on a rumor that Congress is considering reimposing the 30-percent withholding tax, bond prices plunged and the yield increased on Thursday, September 9, 1993.[8] In response, the Treasury Department announced on September 10, 1993 that the Clinton Administration opposes reimposition of the 30-percent withholding tax.[9]

In 1987, Germany announced that it would impose a 10-percent withholding tax on investment income effective in 1989. The proposal was withdrawn six months later after an estimated DM 80 billion outflow of capital. At the beginning of this year Germany imposed a 30-percent withholding tax on investment income but specifically exempted foreign investors to avoid the problems associated with the original 10-percent withholding tax.

An increase in U.S. interest rates would run counter to the purposes of the budget reconciliation bill passed by Congress last month. Proponents argued that the adverse effects of the tax increases and spending cuts in this legislation would be offset by lower long-term interest rates due to deficit reduction. The hoped for reduction in interest rates would, however, be jeopardized by reinstatement of the 30-percent withholding tax. Reinstatement would directly increase federal government spending by increasing the interest rate that the government must pay on new debt issues.

Higher U.S. interest rates also would increase the cost of capital for U.S. companies *vis-a-vis* their foreign based competitors. U.S. reliance on foreign financing has grown ten-fold since repeal of the 30-percent withholding tax: from $32 billion in 1984 to $317 billion in 1992. As shown in the following table, over one-fourth of corporate borrowings are now from foreign markets as compared to only 6 percent in 1984.

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[7] Joint Committee on Taxation, *General Explanation of the Deficit Reduction Act of 1984*, p. 391.

[8] *Wall Street Journal*, September 10, 1993, p. 1. "Bond prices plunged after a sell-off that began overseas swept through the U.S. bond market. The price of the Treasury's benchmark 30-year issue fell nearly 1½ points. Its yield rose to 5.96 percent. Analysts said foreign investors began dumping U.S. bonds overnight on rumors that Congress planned to consider reimposing a 30% withholding tax on foreign investments in U.S. Treasuries."

[9] *Daily Tax Report*, September 13, 1993, pp. G5-G6.

Foreign Portfolio Investment in U.S. Corporate Bonds: 1984, 1992
[Dollar amounts in billions]

Item	1984	1992
U.S. corporate bonds held by foreign portfolio investors	$32	$317
Total U.S. corporate bonds outstanding	$525	$1,118
Percent of U.S. corporate bonds held by foreign portfolio investors	6.2%	28.4%

Sources: U.S. Department of Commerce, Survey of Current Business, June 1993.
Board of Governors of the Federal Reserve System, *Balance Sheets For the U.S. Economy, 1960-1991*, March 1992.
Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*, July 1993.

In conclusion, the Coalition strongly opposes this proposal. Congress was correct in its 1984 assessment of the importance to U.S. business of access to the Eurobond market. Over the last nine years, reliance on foreign financing has increased dramatically. Reinstatement of 30-percent withholding would limit this access and harm economic recovery.

Conclusion

Foreign investment is critical to the success of multinational corporations which play an increasingly important role in the global economy. Therefore, U.S. rules for taxing foreign source income should be formulated taking into account their combined effect, the costs of complexity, and the tax policies of other countries. Piecemeal changes in the nation's international tax regime will inevitably have unintended effects and increase complexity.

MEMBERS OF U.S. MULTINATIONAL CORPORATION INTERNATIONAL TAX POLICY COALITION

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General Electric Co.
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Sara Lee Corporation
United Technologies Corporation

Chairman RANGEL. Mr. Wiacek.

STATEMENT OF RAYMOND J. WIACEK, PARTNER, JONES, DAY, REAVIS & POGUE, ON BEHALF OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. WIACEK. Thank you, Mr. Chairman. My name is Ray Wiacek. I am here today on behalf of the Emergency Committee for American Trade, or ECAT, an organization of some 60 large U.S.-based multinationals concerned with issues that affect international trade and international taxation.

ECAT companies have annual sales of approximately $1 trillion and over 5 million employees. The members of ECAT are strongly opposed to changing the foreign tax credit to a deduction. I think that the fundamental deviation that this represents from standard tax policy and the double taxation that would result are reasonably well known, so I would like to speak just briefly and off the cuff to what I think is the premise underlying this proposal, which comes up, oh, every 3 or 4 years or so.

I think that premise is, one, that the foreign tax credit, by removing the penalty of double taxation, serves as an inducement or incentive to invest abroad, and, two, that investment abroad is harmful to the U.S. economy.

We see this premise sometimes phrased in terms of a "runaway plant" or otherwise. I think nothing could be further from the truth. ECAT just completed a major study circulated to all Members of Congress—it took about 3 years to complete, and was prepared by a number of outside economists using governmental and other data that shows that overseas investment is vital to the health of the U.S. economy.

In fact, the study is replete with data. Among its findings is that the overseas business activities of U.S. companies contributed a net surplus of $130 billion in 1990 to the U.S. balance of payments, and that the net surplus contributed over the decade of the 1980s averaged some $83 billion per year, in a decade in which the United States was otherwise experiencing large deficits.

The study also showed that during 1989–91, 89 percent of the growth in the U.S. economy was attributable to exports, that companies with overseas subsidiaries were responsible for two-thirds of these exports, that the majority of these exports went to their U.S. foreign subsidiaries, and that 93 percent of these exports were sold in the local—that is the foreign marketplace—and were not round-tripped or otherwise sold back to the United States.

There is a lot of data in the ECAT study that I don't want to repeat here. We have a written statement that we have submitted for the record.

I would like to end my oral statement with a couple of anecdotes. In thinking about this testimony, I remembered an article that I read yesterday in the Wall Street Journal and another one in the Sunday Times. The article in yesterday's Journal talked about the expansion into Europe by the U.S. retail industry, particularly U.S. discounters. You might call this the "Walmart in Liverpool" article. I would like to point out that a U.S. store opening in the United Kingdom is not a "runaway" from the United States and does not represent a subtraction from the U.S. economy. In fact, the management fees, the design fees, the dividends and the royalties that will be repatriated back to the United States are very important. The U.S. retail store abroad also provides an outlet for U.S. goods.

The other article in the Sunday Times talked about the boom in Southeast Asia. It said that the Malaysian economy was the most rapidly expanding economy in the world over the last 5 years. The article then went on to note and to lament the lack of U.S. involvement and investment in this area. It noted that there were few U.S. firms with southeast Asian headquarters, few U.S. sales offices calling on customers there, few U.S.-owned warehouses providing parts and service to customers there, and few U.S.-owned plants producing U.S.-designed goods for that area.

As a result of the paucity of U.S. investment, in the region, the article pointed to a project worth $3 billion for the construction of an airport in Kuala Lumpur that had gone to a group of Japanese companies that are all over the area with investment and people, and that did not go to the United States.

I would suggest again that an airport being built in Kuala Lumpur is not a “runaway plant.” Had a U.S. firm won the construction project, then the engineering jobs, the architectural jobs, the supply of radar and electronic products, and the supply of parts by special steel companies from the United States would have been an addition to and not a subtraction from the U.S. economy.

To conclude, U.S. companies invest abroad for business reasons. Investment abroad is good for the U.S. economy and any attempt to deter U.S. foreign investment via the Tax Code or in any other way would in my view be wrongheaded and counterproductive.

[The prepared statement follows:]

STATEMENT OF RAYMOND J. WIACEK, PARTNER, JONES, DAY, REAVIS & POGUE, ON BEHALF OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE, BEFORE THE WAYS AND MEANS SUBCOMMITTEE ON SELECT REVENUE MEASURES HEARING ON A PROPOSAL TO CHANGE THE FOREIGN TAX CREDIT TO A DEDUCTION

SEPTEMBER 21, 1993

I am Ray Wiacek, a partner in the law firm of Jones, Day, Reavis & Pogue and I am here today as tax counsel to the Emergency Committee for American Trade (ECAT) to testify against the proposal to change the foreign tax credit to a deduction.

ECAT is an organization of about 60 large U.S. firms with business activities in competition against corporations from Japan, Germany, and other countries in virtually every market in the world. Companies represented by ECAT have annual worldwide sales of over $1 trillion and they employ about 5 million persons.

The members of ECAT have a critical interest in U.S. taxation of their foreign source income. They are strongly supportive of the foreign tax credit system which is nearly universally practiced by those countries like the United States that tax the foreign earnings of their citizens. It is not used or needed by those countries who do not tax the foreign income of their citizens.

The foreign tax credit provides that taxes paid to foreign governments can be offset or credited against the U.S. income tax on income earned abroad. The foreign tax credit does not permit foreign taxes to be credited against U.S. taxes imposed on income earned within the United States. U.S. law and regulation determine what is U.S. source income and what is foreign source income. The foreign tax credit is designed to avoid double taxation while ensuring that income earned abroad by U.S. firms shall be subject to the higher of either the U.S. or the foreign tax rate.

To enact the proposal to convert the U.S. foreign tax credit into a deduction would be to use the power to tax in the fashion our founding fathers feared - as the power to destroy. This is because a deduction for foreign taxes paid would raise the current U.S. tax rate on foreign source income to between 55 - 60 percent. Our foreign competitors, however, would continue paying their national tax rates of about 35 percent.

Payment of such a double-tax rate by U.S. firms on their foreign earnings could well prove fatal to their global ability to compete and to continue their vital contributions to U.S. employment and economic well being.

A recently released study of ECAT, MAINSTAY II: A New Account of the Critical Role of U.S. Multinational Companies in the U.S. Economy documents the role and contributions of U.S. multinational corporations in the U.S. economy from 1980 - 1991. I believe that an understanding of that role is critical to understanding why changing the foreign tax credit to a deduction would severely impact the U.S. economy.

A brief summary of MAINSTAY II is as follows:

This study examines the role of U.S. multinational corporations in the U.S. economy from 1980 through 1991, with an emphasis on the manufacturing sector. Most of the data relating to U.S. multinational companies and their foreign affiliates are derived from official U.S. Government statistics, principally the U.S. Department of Commerce's annual survey, "U.S. Direct Investment Abroad: Operations of U.S. Companies and Their Foreign Affiliates." Comprehensive benchmark surveys were completed in 1982 and 1989. Data for intervening years are based on slightly less detailed annual surveys. Data on international financial

flows related to direct investment were obtained from U.S. balance-of-payments statistics, as reported quarterly in the "Survey of Current Business." International comparisons are based primarily on Organization for Economic Cooperation and Development (OECD) data.

The study shows conclusively that U.S. multinational companies made strong positive contributions to the U.S. balance of payments throughout the 1980's and into the 1990's. They did so during a decade characterized by a massive deterioration of the U.S. trade balance, its international payments balance, and its global financial position. Indeed, multinational companies are now the single most positive factor in the U.S. balance of payments. Had it not been for the outstanding performance of multinational companies during the 1980's, the international economic position of the United States would have been far worse, given the weaker performance of corporations oriented primarily toward the domestic market.

MAINSTAY II's principal factual findings are as follows:

- ***The overseas business operations of U.S. multinational companies contributed a record net surplus of $130 billion in 1990 to the U.S. balance of payments.***
- ***For the total period, 1982 to 1990, U.S. multinational companies contributed an average net surplus of $83 billion annually to the U.S. balance of payments.***

The report demonstrates that overseas investment by U.S. multinational companies contributes to the health of the companies, to U.S. domestic employment, and to the overall strength of the U.S. economy. Following are the detailed findings of the report.

1

American Companies With Overseas Investments Have Been Waging A Hard Fight And A Successful One - To Keep Exports Flowing From The United States

- ***On the merchandise trade account, their surpluses rose from a net surplus of $46 billion in 1984 to a net surplus of $80 billion in 1990.***
- ***These trade surpluses were earned in almost every industrial sector.***

By contrast, the overall U.S. trade balance for manufactures deteriorated steadily to a deficit of $125 billion in 1987, ending the decade in 1990 with a deficit of $73 billion. Without the enormous balance of payments surpluses of multinational companies, the state of the U.S. balance of payments would have been truly calamitous with concomitant adverse effects on the U.S. economy.

- ***The dramatic deterioration of the U.S. merchandise trade balance in the first half of the 1980's was driven by clearly identifiable macroeconomic forces.***

The most important factors were the overvaluation of the U.S. dollar, up 37 percent in real terms against 40 leading international competitors from 1980-1985, and a rapid growth in U.S. domestic demand in 1982-1985 relative to other industrialized countries. Similarly, the subsequent recovery in U.S. exports and welcome improvements in the merchandise trade balance can be traced to a reversal in these macroeconomic trends. Had U.S. multinational firms not made foreign investments, the trade balance would have been far worse.

- ***Exports by U.S. multinational companies have risen sharply since 1985. (Real U.S. export growth averaged 14 percent annually from 1986 - 1991, the highest for any five-year period in U.S. history.)***

- *U.S. exports accounted for 89 percent of U.S. economic growth during 1989-1991.*

- *U.S. multinational companies accounted for approximately two-thirds of U.S. manufactured exports.*

II

The Net Return On The Foreign Investments Of U.S. Multinational Companies Is The Most Positive Single Element In The U.S. Balance Of Payments Account With The Rest Of The World.

Not only have multinational firms achieved huge surpluses on trade account, the net repatriated earnings from their overseas investments have also been consistently positive as have their overall financial transactions.

- *For 1992, their net repatriated earnings reached $48 billion. These earnings - the share actually brought home to the United States - have been the most positive single entry in the U.S. balance of payments.*

- *While returning substantial trade and balance of payments surpluses to the United States, multinational companies continue to build their operations abroad, thereby assuring future returns. They do this primarily through the reinvestment of overseas earnings and not through the export of funds from the United States.*

III

Investments Abroad Keep American Companies Competitive

- *Investments overseas enable multinational companies to enjoy greater economies of scale, to solidify access to foreign markets, and to sustain the worldwide research and development activities indispensable to maintaining competitiveness in an increasingly global environment.*

U.S. firms and industries that have been the most aggressive in expanding global investments have also been the most successful in expanding both their U.S. exports and global market shares.

- *Industries with the highest levels of foreign investment have the highest rate of exports and export growth.*

Exports to overseas affiliates accounted for a steadily rising share of total exports by multinational companies and are correlated strongly and positively with growth in foreign affiliate sales. This demonstrates a critically important aspect of foreign investment by multinational companies, i.e. that exports follow investment.

- *The higher the share of U.S. direct manufacturing investment in a foreign country, the more likely the U.S. is to have a merchandise trade surplus with that country. (The relative paucity of U.S. direct investments in Japan, for example, is a major reason why U.S. exports to that country are relatively small.)*

IV

Foreign Investment Serves Foreign Markets

- *The underlying motivation for foreign direct investment is to penetrate markets otherwise commercially inaccessible to U.S. firms and then to protect or expand market share. U.S. foreign affiliates thus predominantly serve the foreign markets where they are located - or third-country markets.*

- *Excluding Canada, only 7.2 percent of total sales by U.S. foreign manufacturing affiliates were to the U.S. market in 1990 - a percentage that was remarkably stable throughout the 1970's and 1980's.*

These numbers show that the increasing imports that have been entering the United States in the period covered are rarely being produced by affiliates of American companies. Accordingly, any restrictions on U.S. investment overseas would not meaningfully reduce imports as is often contended by opponents of foreign investments. Rather than replacing domestic production, foreign manufacturing by U.S.-based multinational companies has increased the volume of American exports.

Foreign investments result in exports of intermediate parts and components and may even produce an immediate foreign demand for U.S. capital goods for new facilities or modernization. These investments establish a market for exports of products associated with the goods produced abroad and for exports where local demand exceeds local productive capacity but does not warrant major expansion. Foreign investment helps popularize U.S. trademarks and brand names and to customize products to local need. It enables U.S. companies to put in the kind of service and distribution networks that could not be supported by exports alone.

V

The Growth In U.S. Multinational Companies' Exports And International Investments Has Generated Increased Employment For Their U.S. Workers.

- *In addition to their critical contribution to the U.S. balance of payments noted above, U.S. multinational companies have been and continue to be responsible for significant employment in the U.S. economy - much of which is generated by their foreign investments.*

- *The total number of jobs created directly or indirectly by the manufactured exports of U.S. multinational companies reached 5 million in 1990, based on U.S. Department of Commerce estimates of the number of manufacturing and nonmanufacturing jobs generated per billion dollars of manufactured exports.*

During the 1980's, manufacturing multinational companies had a better record on employment than the typical large U.S. manufacturing firm. With the economic downturn and increased pressure from foreign competitors, employment by U.S. multinational company parents fell slightly from 1982 - 1989. That decline, however, was substantially smaller than the decline in employment by Fortune 500 companies as a whole.

Findings

The above findings demonstrate that the simple contention that multinational companies are harming the U.S. economy by shifting jobs abroad and importing cheaper products into the United States does not bear up to scrutiny. Rather, the exact opposite is true. Investment abroad by multinational companies provides the platform for growth in exports *and* creates jobs in the United States.

The study provides data to back up the fact that companies that think and act globally set the pace for U.S. exports. For such companies, their foreign investments create a constant awareness of market opportunities for U.S. exports, which might otherwise go unnoticed.

As the business and consulting economists who prepared the earlier ECAT "Mainstay" study in 1973 stated: "The conclusions...about the operations of the multinational corporation are based on sound statistics. If they clash with

judgments derived from a combination of isolated incidents and intuition, they can stand their ground."

And A Renewed Warning

There are, however, clouds on the horizon. As the U.S. economy continues its slow recovery and unemployment rates continue to be a concern, proposals have been put forward to limit the ability of multinational companies to invest abroad such as the one to change the foreign tax credit to a deduction. Proposals have also been made to restrict the economic activities of foreign multinationals in the United States.

Enactment of such measures could cripple the international competitiveness of the U.S. economy. On the one hand, the proposals would curtail needed foreign capital for the U.S. economy. On the other, they would limit the ability of U.S. multinational companies to compete globally with firms from Japan, Germany, and elsewhere - firms that are increasing their global market share at the expense of U.S. firms. The U.S. share of annual outflow of direct investment has dropped from two-thirds of the worldwide total in 1967 to one-fifth in 1988-1989. Over the same period, Japan's share grew from 2 percent to 28 percent. The share of the European Community grew from 28 percent to 48 percent.

By measuring the benefits that flow to the U.S. economy from the exports and foreign earnings of multinational companies, MAINSTAY II shows:

> *First, that foreign tax and other investment restrictions could cut into our major surplus balance of payments account with the rest of the world; and*
>
> *Second, by its analysis of how the exports of multinational companies exceed imports by tens of billions of dollars each year, that limits on investment would reduce U.S. exports. This could lead to a chain reaction, lowering the level of world trade, and diminishing the welfare of all participants.*

The numbers in the report establish the positive correlation between investments abroad by multinationals and the propensity of foreign countries to import American products. This gives statistical support to the view that investments mean more access to markets.

Perhaps the most important conclusion validated by the report's data is that multilateral approaches to international trade and investment issues work well. In a foreword to an early ECAT study (and reiterated in ECAT's first "Mainstay" publication) President Dwight D. Eisenhower warned against a return to "an inept, selfish and self-defeating system of economic nationalism." The data in this new study makes even clearer the importance of maintaining the hard-won open system of global trade and investment. In particular, it details the improvement in the U.S. balance of trade that began in 1985 when governments worked together on the problem of the overvalued dollar. And it then shows how American multinationals set the pace in the turn-around in trade that followed - making the case that other difficulties can also be dealt with in a similar fashion without undue or unnecessary risk to U.S. competitiveness, domestic jobs or international economic progress.

Mr. Chairman, as can be seen from the above summary of MAINSTAY II, the employment and foreign trade records of multinational companies and their foreign affiliates demonstrate convincingly that their foreign investment activities have enhanced their export performance, increased their trade surpluses, and consequently have had a strongly positive effect on U.S. manufacturing employment, resulting in an estimated 5 million U.S. workers who owe their jobs, directly or indirectly, to multinational companies' manufactured exports -- exports that follow and that in substantial part are created by U.S. foreign direct investments.

In addition, hundreds of thousands of other U.S. jobs are dependent on the research and development budgets, capital expenditure programs, and corporate staff functions that are supported by the steadily growing stream of earnings being repatriated from the overseas affiliates of U.S. multinational companies to their U.S. parents.

American workers - like their employers and the U.S. economy - have an important stake in the continued growth and prosperity of multinational companies' worldwide operations.

In summary, to change the foreign tax credit to a deduction as proposed would be a prescription for U.S. withdrawal from the global economy and for domestic economic stagnation.

STATEMENT OF JOHN E. ALLIS, CPA, HOUSTON, TEX.

Mr. ALLIS. Mr. Chairman, I am John Allis, a CPA from Houston, Tex. I would like to provide a brief summary of my written comments that I have submitted.

Chairman RANGEL. Without objection, all written statements will be entered into the record.

Mr. ALLIS. I am before the subcommittee in response to the subcommittee's proposal to eliminate the foreign tax credit. I am concentrating on the proposal's effects on individuals who work abroad, that work overseas. This proposal is unfair to individuals that work overseas. They will be paying double tax.

First, they are going to pay tax in the foreign jurisdiction, not only at the country level but also at levels similar to our State and local taxes. Then they are going to pay again to the United States.

It is very conceivable that an American working overseas could pay tax over 100 percent of his salary. While this proposal does keep the provision for deduction in foreign taxes paid, this does not provide any relief to the alternative minimum tax. No one wants to work and pay tax at over 100 percent tax rate. The taxpayers would either have a choice of not complying with the U.S. laws or asking their employer to provide additional compensation to pick up the additional tax cost.

A few key high-level employees may be able to get the company to pay for double taxation, but middle and lower level American workers will not be able to receive this type of compensation. They will be replaced with workers from other nationalities. That is already happening.

Since American employees can be very expensive overseas, it will accelerate this trend. In a global economy, we should be encouraging the smaller- and medium-sized companies to do more business overseas, to go overseas and export their products more.

With labor costs of American workers so high, under this proposal, if it is enacted, they will not be able to employ Americans abroad. It will stifle the growth of these American companies.

Thank you very much.

[The prepared statement follows:]

TESTIMONY OF JOHN E. ALLIS
CERTIFIED PUBLIC ACCOUNTANT

The Subcommittee on Select Revenue Measures, Committee on Ways and Means, announced a miscellaneous revenue-raising proposal in Press Release #10, Foreign Tax Provisions (4), "to change the foreign tax credit to a deduction." This proposal, if enacted, would inequitably subject American workers to double taxation. American workers would not be able to take jobs outside the U.S. without additional compensation as reimbursement for the double taxation. Americans would not be competitive in the international marketplace.

The United States is the only major country which taxes its citizens and residents on worldwide income. While the Sec. 911 exclusions offer relief in some circumstances, Americans who work abroad usually pay tax at the greater of the foreign or U.S. tax rate. This makes Americans more expensive to hire than other nationalities. Under this proposal, Americans would be prohibitively expensive to employ abroad.

Several examples below explain the severe impact on individuals of this proposal, if enacted.

Double Taxation

A taxpayer may currently claim foreign taxes as an itemized deduction or offset U.S. tax on foreign source income with a foreign tax credit. The proposal would eliminate this credit. The credit is limited to the lesser of foreign taxes paid or the percentage of U.S. tax on foreign source income. The following example illustrates the current taxation of a married American with children who works abroad for the entire year.

	Current Law
Cash Paid to Employee	
Base Salary	$35,000
Bonus	5,000
Benefits-in-Kind Taxable to Employee	
Children's American Schooling	10,000
Additional Foreign Housing Expenses	20,000
Airfares for Home Leave	10,000
Foreign Tax @ 50% of Gross Income (Reimbursed by Employer)	80,000
Gross Income	$160,000
Deduction (Standard)	(6,200)
Exemptions	(9,400)
Taxable Income	$144,400
Federal Income Tax	$37,513
Foreign Tax Credit	(37,513)
Alternative Minimum Tax (AMT)	3,185
AMT Credit (claimed upon repatriation)	(3,185)
U.S. Tax Liability	$ - 0 -
Foreign Income Tax Liability	$80,000
U.S. Tax Liability	- 0 -
FICA - OASDI	3,571
FICA - Medicare	2,320
Worldwide Tax Burden - Current Law	$85,891

John E. Allis
Certified Public
Accountant
2121 San Felipe
Suite 141
Houston, Texas 77019
Telephone 713-529-8700
Fax 713-526-3395

The Alternative Minimum Tax (AMT) paid by the taxpayer in the above example may later be claimed as credit when the taxpayer has U.S. source income (e.g., upon repatriation).

The Proposed Provision eliminates the foreign tax credit and continues to allow a deduction for the foreign taxes paid. The example below details the effects of the proposal.

	Proposed Law
Cash Paid to Employee	
Base Salary	$35,000
Bonus	5,000
Benefits-in-Kind Taxable to Employee	
Children's American Schooling	10,000
Additional Foreign Housing Expenses	20,000
Airfares for Home Leave	10,000
Foreign Tax @ 50% of Gross Income (Reimbursed by Employer)	80,000
Gross Income	$160,000
Deduction (Foreign Taxes Paid)	(80,000)
Exemptions	(9,400)
Taxable Income	$70,600
Federal Income Tax	$14,971
Foreign Tax Credit	N/A
Alternative Minimum Tax (AMT)	16,879
AMT Credit	- 0 -
U.S. Tax Liability	$31,850
Foreign Income Tax Liability	$80,000
U.S. Tax Liability	31,850
FICA - OASDI	3,571
FICA - Medicare	2,320
Worldwide Tax Burden - Proposed Law	$117,741

The taxpayer may not claim the above AMT as a credit in future years.

Under the Proposed Law the worker is double-taxed: once by the foreign country and again by the U.S. The worker's take-home (after-tax) pay is only $2,259!

Base Salary		$35,000
Bonus		5,000
Cash Paid to Employee		$40,000
U.S. Tax Liability	$31,850	
FICA - OASDI	3,571	
FICA - Medicare	2,320	(37,741)
Take-Home Pay		$ 2,259

Almost the entire cash compensation is consumed by taxes in this scenario. An employee could easily pay tax at rates of over 100% in some foreign jurisdictions.

John E. Allis
Certified Public
Accountant
2121 San Felipe
Suite 141
Houston, Texas 77019
Telephone 713-529-8700
Fax 713-526-3395

Compensation Expense

An employer provides English language education for the employee's children when the foreign assignment location schooling is not adequate. The company may also pay additional housing expenses to keep the employee's family in suitable housing. Both private and Federal employers also provide other benefits-in-kind, such as home leave and cost of living allowances, to mitigate the higher costs of living outside the United States. These benefits attempt to keep the employee in the same position as at the home location. An employee will not accept foreign employment when the additional costs exceed the benefits.

For the worker to accept foreign employment, the employer would need to reimburse the double taxes assessed under the proposed law. Under standard corporate tax reimbursement policies, the employee pays tax on the actual cash payments received as if the employee had stayed at home. The employer reimburses any additional tax resulting from the foreign assignment. The following examples illustrate this concept.

Stay-At-Home Tax

Base Salary	$35,000	
Bonus	5,000	
Stay-Home-Compensation	$40,000	
Standard Deduction	(6,200)	
Personal Exemptions	(9,400)	
Stay-at-Home Taxable Income	$24,400	
Stay-at-Home Income Tax	$3,660	
Stay-at-Home FICA - OASDI	2,480	
Stay-at-Home FICA - Medicare	580	
Employee's Share of Tax Burden	$6,720	(A)
Worldwide Tax Burden - Proposed Law	$117,741	(B)
Employer's Tax Reimbursement (B) - (A)	$111,021	
Foreign Taxes	80,000	
Employer Paid U.S. Taxes - Proposed Law	$ 31,021	

The employer paid taxes are an additional cost to the employer for the employee's foreign assignment. The taxes are also taxable compensation to the employee which would need to be grossed up for the tax-on-tax in the following year.

Employer Paid U.S. Taxes - Proposed Law	$ 31,021
Foreign Tax Gross Up (50%)	68,783
Federal Income Tax Gross Up (26%)	35,767
FICA - OASDI Gross Up (at Maximum)	N/A
FICA - Medicare Gross Up (1.45%)	1,995
Additional Employer Compensation Expense	$137,566

In the following year the employer would pay $137,566 in additional tax reimbursements due to the Proposed Law. The tax-on-tax gross up would continue to spiral upwards until the employee returns to the United States.

John E. Allis
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2121 San Felipe
Suite 141
Houston, Texas 77019
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Fax 713-526-3395

Note on Sec. 911 Exclusions

For simplicity the exclusions available under Internal Revenue Code §911 are not discussed in the above examples. The Sec. 911 exclusions do offer relief to some taxpayers. For taxpayers in higher tax countries, however, the main benefit of these exclusions is a decrease in the marginal U.S. tax rate. In addition Internal Revenue Code §911(d)(6) allows foreign taxes to be claimed as a credit or deduction only for income which has not been excluded. Illustrations which detail the disallowance of the foreign tax credit (Current Law example) and of the deduction for foreign taxes paid (Proposed Law example) would only complicate the comprehension of this subject matter.

Conclusion

Competition is intense in the global marketplace. American companies that hire American workers are already under strong pressure to reduce costs in order to secure business outside the U.S. Additional compensation expenses from double taxation under the Proposed Law would mean that more foreign projects would be awarded to Japanese, European and other non-U.S. companies. American workers and companies would suffer. The Subcommittee on Select Revenue Measures should not give further consideration to the proposal to change the foreign tax credit to a deduction.

Chairman RANGEL. Mr. Allis, I appreciate your remarks about small business, but as relates to the individual American taxpayer in the foreign countries, the committee was criticized because of what has been perceived to be an overgenerous tax treatment for I think upward of $70,000 tax free, and I have to assume that all of that was taken into consideration when you were preparing your statement?

Mr. ALLIS. Absolutely.

Chairman RANGEL. And that did not make our taxpayers abroad feel on a fair equitable tax basis with foreigners from other countries that are located in the same countries?

Mr. ALLIS. It certainly doesn't make it equitable. Someone from the U.K., once they leave the U.K., they are subject to tax in their new location. They break the ties with their old location.

Chairman RANGEL. Let me say this: How we do it is one thing. If it is bad tax policy, you can address yourself to that. But the bottom line I think is that all members on the committee and off the committee are trying to make certain that our taxpayers, individually and corporate, are not held back because of our tax decisions, but feel that they can go in and compete with any other nation and pay an equitable share, but certainly not more than that proportion of their pay as any other foreigner that is seeking the same job.

Leaving the corporations alone and getting back to individuals—because an individual when offered a job abroad has to consider what is the pay, what is the cost of living, where do I send the kids to school, what is the housing situation, and how much is Uncle Sam going to leave in my pocket as well as the other country? With a $70,000 exclusion in one pocket, the very least we should hear is that is good and that will influence our decision as to how we can be competitive and you can say it is not enough, but you cannot ignore it and then talk about others getting a credit while you may be getting a deduction.

You wouldn't care what we called it if we increased the exemption.

Mr. ALLIS. The exemption provides relief in lower tax countries, but for someone in a higher tax country, it provides very little relief. I have seen tool pushers with base salaries of $20,000 having a $200,000 W–2. The type of taxes they are paying under the current system, where they are keeping from being double taxed, it is equitable. The $70,000, in a high tax country, they don't get the benefits of that.

Chairman RANGEL. Do you think we should have something to index it, according to the cost of living in the country?

Mr. ALLIS. That would help in low tax jurisdictions, but in high tax jurisdictions, that would have no effect or very little effect in terms of the Internal Revenue Code.

Section 911(b)(6) prevents the taxpayer from getting a double benefit of the $70,000 a year and the foreign tax credits.

Chairman RANGEL. With the corporations, what if it is a credit or a deduction—the whole idea is to make certain it doesn't cost our businesses more to operate abroad than here. That is the bottom line—so that we are competitive or indeed if there is some way to even give you an advantage if it is not illegal under international treaties.

When you get taxed by a foreign country, it involves their tax policy, which may not be our tax policy, but to the corporation, that is it; that is what you pay.

When we give a deduction, and you have to assume it is going to be equitable enough to make you competitive, then the tax that would be directed at you would be based on our tax policy and the deduction is really a business expense that whether you like the policy or not you are doing business in the country. This is your license. This is your fee. This is what you have to pay, and you don't debate it either way.

If you were assured that the deduction or that any changes in the law—it is not my bill—would not put you at a disadvantage than what you are under existing law, as tax policy, do you think it would be better to use a deduction or credit?

Mr. WIACEK. I think it would be very hard to design a deduction that wouldn't be a disadvantage versus the credit. The real point here is to make sure that we are competitive with everybody else doing business in foreign areas so that we can take advantage of those marketplaces.

Chairman RANGEL. I am assuming that.

Mr. WIACEK. When we go to Germany or to France and pay 52 or 34 percent tax rate for which the United States only gives us a deduction, then we can't be competitive in those countries. U.S. firms would be double-taxed whereas the firms of all other countries, would be paying one tax. With that much of a burden, U.S. firms could not be competitive.

One frequent misunderstanding in the debate about tax policy is that when people start talking about leveling the playing field and making things equal, they forget that we don't control the international field. We can get rid of incentives within the United States, we can do all the 1986 flat tax stuff that we want, but when we are talking about whether we can land a contract in Germany, we have to remember that there are other players and other tax codes as well.

So what you need to do is free us up to compete in Germany on the same basis that the Germans and Japanese and Koreans and French compete in Germany.

Chairman RANGEL. OK. It seems to me that this is a very important factor as to whether or not you can effectively compete on a level playing field. Are all of you satisfied that no other industrialized country uses the deductions.

Mr. MERRILL. Mr. Chairman, on my written statement, there is a list of the 24 major industrial countries in the world, the members of the OECD.

Of the 24, 12 used the foreign tax credit system which was the U.S. system, taxing the foreign source income of their multinationals, but providing a credit for the foreign taxes up to the domestic country's tax on that income.

The other 12 exempt dividends. They take the approach that they are not going to tax foreign source income from active business at all and they just let the foreign country tax it. No country in the world that I know of, certainly no industrial country, has a deduction system, in other words taxing the foreign source of income of a multinational and allowing only a deduction.

Chairman RANGEL. I wasn't debating it. I wanted to make sure you agreed with whomever said it.

Are you satisfied that if the tax system is equitable and allows you to compete based on taxes, that U.S. businessmen are properly trained to negotiate contracts with U.S. firms with the same type of knowledge of the foreign country's culture and language?

There is a lot of criticism that the Japanese and others know us, but that our people just get over there and they haven't the slightest idea where they are, what they are doing there. That is not a criticism. It is whether you are satisfied that U.S. business people that you represent are just as competitive as foreign business people, leaving the tax question aside?

If you are not, is there any reading in the industry that you would suggest that most of you look at and could affirmatively say that this is an area that we have to shore up and make certain that our people are more competitive and better understanding of where we want to go?

Mr. WIACEK. This is a personal observation based on my own practice and experience and less on member companies of ECAT. I would say that we are extremely competitive in Europe. For example, in recent years the profits of European subsidiaries of U.S. firms provided the necessary cash flow to keep the competitive door open.

I spent the last week in Japan and it is quite different there. I think it is probably hard for our people. I was there with U.S. businessmen looking at their Japanese subsidiary and their Japanese operations. The language is a lot different from European languages, the alphabet is different as are ways of conducting business.

Chairman RANGEL. Do you see that as a part of our foreign policy that we are moving our educational systems toward a global competitive position in terms of languages and skills?

Mr. WIACEK. The fact that we are talking about it I think is a major improvement over maybe a decade ago.

Chairman RANGEL. Does everyone agree that there has been a major improvement in terms of our ability to deal in Asia generally? I am talking about Singapore and Hong Kong, Taiwan and China as well as Japan. Is everyone satisfied that when you meet your counterparts in the hotel lobbies with your Japanese competitors, that we are OK?

After all, I am not in that. You probably hear a lot of unfair criticism about politicians and Members of Congress, but some of the foreigners like to tweak us about not being able to live up to our reputation. They laugh sometimes at what we send over there. Many times we find ourselves as being salesmen for American firms that are competing in countries that we are visiting only to find out that we were ignored.

Some of the responses, not necessarily true, meant that we never really gave the type of presentation that Japan had given and other countries had given. Again I don't say this as a criticism, but I think the Congress has a responsibility if not in this committee but in others, not just to deal with taxes to make us competitive, but to deal with the whole ball of wax.

If you have any ideas that you could send to me that I could present to the full committee to make our team more competitive, taking into full consideration that your primary purpose is to deal with the tax exemption, I would appreciate it.

Second, I accept the fact that you believe that exports create more jobs and higher-paying jobs and all of you believe that the North American Free-Trade Agreement would do just that and all of you would support it.

I would ask the same question in a different way: Do you believe that Americans who would be involved in manufacturing and in selling services and in taking over these high-tech jobs—are we ready to do it, assuming everything works, increase in commerce, increase in the economy?

Are you satisfied that our education and training system is geared so that when the opportunity comes, we are ready, and is there any talk about the number of people in America that are not involved in all this competition that you are talking about? They are in jails or in the streets or are really unemployable. The last thing in the world that we can talk about as a country is supporting them, losing the potential, losing the tax revenue, and losing the skills.

The last administration said it was costing us now $300 billion a year when you throw in productivity and lost revenue. Is this anything that is discussed in board rooms or do you just believe the Congress and local governments are going to handle it?

Is there anyone who doesn't understand the question?

Mr. GREEN. I understand the question.

Chairman RANGEL. I am talking about competition. The same thing you are talking about with taxes, I am just talking about the whole package. I would hate to believe that we gave you a favorable tax package and sent people to go abroad and everything worked out and then we fall down in some other area.

Mr. MERRILL. Mr. Rangel, I think I understand the issue, that as we compete in a global economy, some of our population will be left behind and some will prosper. Those that have the skills, the education and languages will prosper.

Chairman RANGEL. Sounds like it is something that we can tolerate, and so I am not the least bit concerned that everyone doesn't make it with those people that do. This is something you have to expect, you are handicapped. Those that are exposed to opportunities and don't accept it—I write that off. I am really talking about as a percentage of our population and a percentage of the amount that we have to expend to support these people that have the potential—I am not talking about some in the sense that some business failed and some business succeeds and therefore we just have to fold that in.

To reword it, is the some that you are thinking about sufficient enough to review that it could impede our progress in these areas, or do you believe that the success will just consume these; that it is a minor setback?

Mr. MERRILL. I was going to say that there are perhaps two strategies for addressing the problem. One is to wall off the U.S. economy from competition with the rest of the world, protect U.S. workers from low-wage workers in other countries.

Chairman RANGEL. Are you saying that my question is so insignificant that the only answer to it would be——

Mr. MERRILL. No, I am not.

Chairman RANGEL. Does my question make you think that the answer could possibly be—what would make you think that is one answer?

Mr. MERRILL. I think we have in fact testimony submitted today arguing in fact that we should erect high tax barriers to U.S. companies operating abroad to help the domestic work force.

Chairman RANGEL. I think I made it clear that assuming that you are satisfied with the tax policy and I was talking about another policy, which I just don't remember suggesting that it meant to protect American labor and build up a wall of competition—I can't even see where you got that idea. You are looking at me and thinking that may be a view I had and didn't express—I am talking about what I expressed. I am not talking about those people who are working that would lose their jobs or that would get lost in the transition.

You expect that if you are making trucks and converting them to boats, somebody is going to lose their job. I am asking do you have people that can make boats? I am also asking whether or not you believe we have a sufficient labor market, whether or not the burden of the unemployed and the unemployable is a burden that is so heavy that it might impede or is it just something that every industrialized country has to accept?

It has nothing to do with building up walls unless you can show me how that works.

Mr. MERRILL. Perhaps I misunderstood your question. The strategy that I would advocate is a strategy that says that we do not attempt to protect the U.S. economy from competition abroad that might be injurious to some of our workers, but instead——

Chairman RANGEL. Did I say anything that inferred that we should stop competition from abroad? I thought I was suggesting that if we can make American firms more competitive, if we can increase their economy and get them more involved, that would increase demand and therefore look to the United States as a larger producer, increase our exports and then deal with the high-tech jobs.

No, it is clear that I don't have the ability to make my questioning clear to you.

Mr. WIACEK. Mr. Chairman, you asked a moment ago whether any of us understand the question and do we know if our clients or member organizations are concerned with such important issues.

I think, yes, certainly they are. I think it is an interesting and important discussion and catches a few of us flat footed who are here to talk about other issues. It is clearly the bigger issue. A number of the member companies in ECAT are companies that you know with headquarters in New York City, that have CEOs that are friends of yours, that have stayed in the city as other people have left the city, and I know from these people that they care very much and are concerned about the educational abilities of the American labor force, and are also greatly concerned about the effect of crack and other things in our cities.

I am from Detroit and grew up in the inner city. When I go back there, Detroit is just a wasteland; it is appalling. These discussions are held and corporations support programs where they can, and we have to keep doing more.

I don't have an answer for you.

Chairman RANGEL. But you are right on target and I don't expect that corporations would do any more than be helpful as they have in New York with the partnership and the Chamber of Commerce and the variety of other type of agreements and working with local, State and Federal Government and we do hope even the pilot demonstration projects in connection with the enterprise zones will be a test place for the corporate structure and government to see what we are doing wrong, what we are doing right and how we can do it better.

You are right on target with the thrust of my question. I hoped that maybe in the private sector they might have suggestions as to how we could perfect a better labor market, how we could have people that would think in terms of whether or not they prospered this year or the next decade that there was hope that maybe the kids would be involved with this rising tide.

As we had with all of us who came to this country from some other country, it wasn't a question as to whether we were going to get rich merely because the corporations received more favorable tax treatment or were able to get large sums of moneys. We accept the fact that is where investment comes from, but there is also the hope with the emigrants that the kids and grandkids would do better.

To me it is not a problem of the poor and communities that I represent. It should be an American problem and I don't expect that the private sector would say they have the answer, but to use their influence to be able to push their governments, local, State and Federal, to make certain that when they are ready to move forward and compete that America gives us the type of labor market in all areas that you would be able to be superior as the United States used to enjoy.

Because of the sensitivity of the question, many people would think that just showing some concern and compassion about this, that automatically you are talking about protectionism and that you want to build a wall between other countries and that you don't want to compete and that we all will just be poor here together, and I didn't mean to suggest that with my question and I will work hard to rewrite those questions so that it would not be offensive to any of you.

Thank you very much and I may send other questions to you in writing.

Our last panel—I apologize for the delay in getting to you. We have here contractors—Don Owen, executive vice president, P&P Contractors, Associated Builders and Contractors, Rockville; Associated General Contractors of America, Robert Desjardins, executive vice president and treasurer, Cianbro Corp. from Maine; Gerald Herr, vice chairman, Washington Interest Program Committee; Sally Sumner, chairperson, Nurse Brokers and Contractors of America; James C. Pyles, counsel, Home Health Services and Staffing Association.

Your full statements will be in the record. I hope you manage to include the fact for those who believe there is a role for the independent contractors, that you deal with the question of abuse which is probably the biggest problem that we face, abuse and failure to pay health benefits and Social Security.

Don Owen.

STATEMENT OF DON OWEN, EXECUTIVE VICE PRESIDENT, P&P CONTRACTORS, INC., ROCKVILLE, MD., ON BEHALF OF ASSOCIATED BUILDERS & CONTRACTORS, INC.

Mr. OWEN. Good afternoon, Mr. Chairman.

I am Don Owen and I am pleased to testify on behalf of the Associated Builders and Contractors. I am executive vice president of P&P Contractors. We are a drywall contracting business located here in the Washington metropolitan area, Rockville, Md.

ABC is a national trade association which represents nearly 16,000 builders, contractors and construction-related employers. We acknowledge that the independent contractor issue is controversial and has been the topic of many congressional hearings through the years.

The Associated Builders and Contractors is opposed to the proposal, which would repeal the safe harbor under section 530 of the Revenue Act of 1978 which relates to the classification of workers as independent contractors. We emphasize that section 530 is not the cause of worker misclassification problems that may exist in the construction industry. Further, we do not believe that repealing section 530 for construction employers will cause the problem of worker misclassification to go away.

ABC is absolutely committed to upholding proper business practices. We believe unscrupulous contractors who shirk their responsibilities or knowingly misclassify their workers should definitely be held accountable under the law. In our business, contractors who practice misclassification have an unfair competitive edge over those of us who play by the rules.

At the same time, there are certain segments of the construction industry where the legitimate use of independent contractors is common, particularly in drywall contracting. These are licensed, insured small contractors or subcontractors who may work on a single major project for one contractor and then move on to other contractors through the years. But the fact that they stay on one project for a long period of time often brings up this issue of control of the personnel, which leads to questions over misclassification.

Under the 20 common law point test, these contractors can occasionally be misinterpreted as employees. By virtue of standard industry practice, however, they are not. Instead it is generally accepted that they are in fact independent contractors.

Also it is not uncommon for people who are involved in our business as employees to work during off hours and weekends as independent contractors. This is how many small contractors get their start, especially those who are economically disadvantaged.

In fact, my company was started in this manner back in 1963. Our founders were French Canadian Americans who barely were able to speak English who were given an opportunity by an established progressive contractor. Today we are one of the largest drywall contractors in the Nation and have also empowered dozens of new viable subcontractors over the years. Some are very strong competitors, I might add, at this time.

ABC believes this particular proposal will hurt the growth potential of new startup enterprises because established contractors will be less likely to risk creating subcontracting opportunities. This comes at a time when we are actively pursuing new startup minority, women owned and other DBE subcontractors for both private sector jobs and Federal projects, some of which require this type of minority participation on jobs.

We suggest that the committee look back to the congressional intent behind section 530. While there may be room for improvement to the statute, we believe that section 530 has served an important purpose and is not merely a convenient loophole for businesses.

ABC recommends that the committee consider amending section 530 so that the IRS is free to publish guidance on employee independent contractor status through regulations or rulings. Congress should tackle the ambiguous 20 point common law test and work on better defining worker classifications, while recognizing the validity of independent contractors, such as small startup contractors who deserve full opportunity to grow and prosper.

ABC believes that targeting construction on the basis of other shortcomings which exist in employment law is unfair. Therefore we urge the committee to drop this proposal from consideration.

Thank you for this opportunity. ABC looks forward to working with this committee on this issue in any way that we can be helpful. I will be submitting a full statement for the record.

Thank you.

[The prepared statement follows:]

TESTIMONY OF DON OWEN, EXECUTIVE VICE PRESIDENT
P & P CONTRACTORS, INC., ROCKVILLE, MARYLAND

REPRESENTING

ASSOCIATED BUILDERS & CONTRACTORS
1300 NORTH SEVENTEENTH STREET
ROSSLYN, VA 22209

BEFORE THE SELECT REVENUES MEASURES SUBCOMMITTEE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

A PROPOSAL TO REPEAL THE SAFE HARBOR UNDER SECTION 530 OF THE REVENUE ACT OF 1978 (RELATING TO THE CLASSIFICATION OF WORKERS AS INDEPENDENT CONTRACTORS) FOR CONSTRUCTION INDUSTRY EMPLOYERS

SEPTEMBER 21, 1993

MR. CHAIRMAN AND HONORABLE MEMBERS OF THE SUBCOMMITTEE, MY NAME IS DON OWEN AND I AM PLEASED TO TESTIFY ON BEHALF OF THE ASSOCIATED BUILDERS AND CONTRACTORS (ABC) I AM EXECUTIVE VICE PRESIDENT OF P&P CONTRACTORS, A DRYWALL CONTRACTING BUSINESS IN ROCKVILLE, MARYLAND.

ABC IS A NATIONAL TRADE ASSOCIATION WHICH REPRESENTS NEARLY 16 THOUSAND BUILDERS, CONTRACTORS AND CONSTRUCTION RELATED EMPLOYERS.

AS THE MEMBERS OF THE SUBCOMMITTEE KNOW, THE INDEPENDENT CONTRACTOR ISSUE HAS BEEN AROUND FOR MANY YEARS AND IS ALWAYS CONTROVERSIAL. TODAY WE ARE HERE TO DISCUSS A VERY SPECIFIC PROPOSAL AFFECTING EMPLOYMENT LAW BEFORE I GET TO THAT I WANT TO REITERATE ABC'S POSITION ON THE MATTER OF INDEPENDENT CONTRACTORS AND DESCRIBE HOW INDEPENDENT CONTRACTORS ARE USED IN THE DRYWALL BUSINESS.

ABC IS COMMITTED TO UPHOLDING PROPER BUSINESS PRACTICES FROM TIME TO TIME OUR ASSOCIATION HEARS FROM FRUSTRATED MEMBERS WHO COMPLAIN THEY HAVE BEEN HARMED BY INDEPENDENT CONTRACTOR ABUSE. OUR MEMBERS OBJECT TO UNSCRUPULOUS CONTRACTORS WHO FAIL TO PAY FEDERAL AND STATE PAYROLL TAXES, WORKER'S COMPENSATION, PLUS HEALTH INSURANCE AND PENSION CONTRIBUTIONS. BY AVOIDING THESE TAXES AND OTHER COSTS, SUCH CONTRACTORS HAVE AN UNFAIR COMPETITIVE EDGE IN THE BIDDING PROCESS. THOSE INDIVIDUALS, WHO IN BAD FAITH WRONGFULLY CLASSIFY THEIR WORKERS FOR ECONOMIC GAIN, SHOULD PAY THE PRICE.

IN MY BUSINESS, INDEPENDENT CONTRACTORS ARE USED FOR SPECIFIC TRADE TASKS SUCH AS FRAMING CREWS, DRYWALL HANGING AND FINISHING

CREWS. THESE ARE SMALL, INSURED CONTRACTORS WHO MOVE FROM JOB TO JOB, COMPANY TO COMPANY AND WORK INDEPENDENTLY. THIS SYSTEM IS USED ONLY FOR MAJOR PRODUCTION JOBS, NOT SMALL JOBS OR PROJECTS WHICH WE FULLY "CONTROL." IT IS NOT UNUSUAL FOR THESE INDIVIDUALS TO WORK AS EMPLOYEES DURING REGULAR HOURS AND AS INDEPENDENT CONTRACTORS DURING OFF-HOURS AND WEEKENDS. THIS IS THE WAY MANY OF OUR MEMBERS GOT THEIR START RUNNING THEIR OWN BUSINESS. HENCE, THIS PRACTICE ALLOWS SMALL CONTRACTORS TO GROW AND PROSPER AND IN FACT, BECOME COMPETITORS. UNDER THE 20 COMMON LAW POINT TEST THESE CONTRACTORS CAN OCCASIONALLY BE MISINTERPRETED AS EMPLOYEES. BY VIRTUE OF STANDARD INDUSTRY PRACTICE, HOWEVER, THEY ARE NOT. INSTEAD, IT IS GENERALLY ACCEPTED THAT THEY ARE INDEPENDENT CONTRACTORS.

AS WE SAID IN OUR TESTIMONY BEFORE THIS SUBCOMMITTEE IN JULY OF LAST YEAR, ABC SUPPORTS EFFORTS BY CONGRESS TO CLARIFY, MODERNIZE AND IMPROVE THE TAX TREATMENT OF WORKERS. CLEARLY THE REPEAL PROPOSED TODAY WILL NEITHER IMPROVE OR CLARIFY THOSE PROBLEMS OR OTHERS ASSOCIATED WITH SECTION 530.

IT COMES AS NO SURPRISE THAT ABC STRONGLY OPPOSES THE REPEAL OF THE SAFE HARBOR UNDER SECTION 530 OF THE REVENUE ACT OF 1978 (RELATING TO THE CLASSIFICATION OF WORKERS AS INDEPENDENT CONTRACTORS) FOR CONSTRUCTION INDUSTRY EMPLOYERS

THIS PROPOSAL WILL SEVERELY IMPACT THE NURTURING AND ESTABLISHMENT OF NEW, INDEPENDENT BUSINESSES. MANY OF OUR MINORITY BUSINESS ENTERPRISES (MBE), WOMEN BUSINESS ENTERPRISES (WBE) AND DISADVANTAGED BUSINESS ENTERPRISE (DBE) MEMBERS COULD NOT BUILD UP THEIR BUSINESSES IF THEY COULD NOT WORK AS INDEPENDENT CONTRACTORS WHILE BEING EMPLOYED DURING REGULAR HOURS AS AN EMPLOYEE.

THIS ITEM IS ON THE AGENDA SINCE IT IS A POSSIBLE REVENUE RAISER. THE IRS HAS SINGLED OUT THE CONSTRUCTION INDUSTRY AS AN ABUSER BECAUSE IRS RESEARCH REVEALS PATTERNS OF NONCOMPLIANCE IN THIS AREA. THE INDUSTRY, AS A WHOLE, FACES A UNIQUE PROBLEM DUE TO ITS HIGH NUMBER OF TRANSIENT AND SEASONAL WORKERS AS RECENTLY AS THIS SUMMER THE HOUSE APPROPRIATIONS COMMITTEE EXPRESSED "CONCERN THAT SOME CONTRACTORS IN THE CONSTRUCTION INDUSTRY ARE MISCLASSIFYING EMPLOYEES AS INDEPENDENT CONTRACTORS." THE COMMITTEE INSTRUCTED THE IRS TO HIRE AND TRAIN ADDITIONAL AUDIT PERSONNEL TO ENFORCE CLASSIFICATION RULES FOR CONSTRUCTION. THE IRS IS ALSO CHARGED WITH REPORTING BACK TO THE COMMITTEE ON ITS FINDINGS OF MISCLASSIFICATION WITHIN CONSTRUCTION, INCLUDING , ON A STATE BY STATE BASIS, THE NUMBER OF INVESTIGATIONS IT HAS UNDERTAKEN.

THE COMMITTEE MUST REMEMBER THAT SECTION 530 IS NOT THE CAUSE OF WORKER MISCLASSIFICATION PROBLEMS THAT SUPPOSEDLY EXIST IN THE CONSTRUCTION INDUSTRY. ELIMINATING THIS PROTECTION FOR CONSTRUCTION IS UNWARRANTED AND WILL CAUSE THE DEMISE OF MORE BUSINESSES IN AN INDUSTRY THAT LOST NEARLY A MILLION JOBS DURING THE RECENT RECESSION. BEFORE ACTING HASTILY, ABC BELIEVES IT IS IMPORTANT TO EXAMINE THE ORIGINS OF SECTION 530 AND THE INTENT OF CONGRESS IN CREATING THE PROVISION. SECTION 530 WAS INITIALLY INTENDED:

> "TO PROVIDE INTERIM RELIEF FOR TAXPAYERS WHO ARE INVOLVED IN EMPLOYMENT TAX STATUS CONTROVERSIES WITH THE IRS AND WHO POTENTIALLY FACE LARGE ASSESSMENTS, AS A RESULT OF THE

> SERVICE'S PROPOSED RECLASSIFICATION OF WORKERS, UNTIL THE CONGRESS HAS ADEQUATE TIME TO RESOLVE THE MANY COMPLEX ISSUES INVOLVED IN THIS AREA." [General Explanation of the Revenue Act of 1978 prepared by the Staff of the Joint Committee on Taxation, p. 301]

THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 MADE RELIEF PERMANENT BECAUSE CONGRESS FAILED TO ESTABLISH NEW STANDARDS FOR DETERMINING INDEPENDENT CONTRACTOR/EMPLOYEE STATUS.

SECTION 530 WAS CREATED AS A WAY TO RESOLVE DIFFICULT PROBLEMS IN AN ACKNOWLEDGED AMBIGUOUS AREA. SECTION 530 PROHIBITS THE IRS FROM CORRECTING ERRONEOUS CLASSIFICATIONS OF WORKERS AS INDEPENDENT CONTRACTORS FOR EMPLOYMENT TAX PURPOSES, INCLUDING *PROSPECTIVE* CORRECTIONS, AS LONG AS THE EMPLOYER HAS A REASONABLE BASIS FOR ITS TREATMENT OF THE WORKERS AS INDEPENDENT CONTRACTORS. ACCORDING TO ACCOMPANYING REPORT LANGUAGE "REASONABLE BASIS" IS TO BE CONSTRUED LIBERALLY IN FAVOR OF THE TAXPAYER. (See H.R. Rep. No. 95-1748, 95th Cong., 2d Sess. 5 1978, 1978-3 Vol. 1 C.B. 629,633.)

THE TAXPAYER CAN SATISFY THE REASONABLE BASIS BY MEETING ONE OF THREE STATUTORY SAFE HAVENS OR BY DEMONSTRATING BY OTHER REASONABLE MEANS A BASIS FOR THE EMPLOYER'S TREATMENT OF THE WORKER. THE THREE STATUTORY SAFE HARBORS INCLUDE RELIANCE ON: 1) JUDICIAL PRECEDENT, PUBLISHED RULINGS, LETTER RULINGS OR TECHNICAL ADVICE MEMORANDA; 2) A PAST IRS AUDIT; 3) A LONG-STANDING RECOGNIZED PRACTICE OF A SIGNIFICANT SEGMENT OF THE INDUSTRY IN WHICH THE WORKER WAS ENGAGED. THERE IS NO REQUIREMENT THAT THE PRACTICE BE UNIFORM THROUGHOUT AN INDUSTRY.

RELIEF UNDER SECTION 530 IS CONTINGENT ON THE EMPLOYER CONSISTENTLY TREATING THE WORKER OR ANY OTHER WORKER SIMILARLY SITUATED, AS AN INDEPENDENT CONTRACTOR. THE EMPLOYER MUST FOLLOW THE STATUTORY REQUIREMENTS FOR PAYMENTS TO INDEPENDENT CONTRACTORS AS WELL.

ABC NOTES THAT IN ORDER FOR A BUSINESS TO QUALIFY FOR SECTION 530 PROTECTION, STRICT CONDITIONS FOR ELIGIBILITY MUST BE MET. WE DO BELIEVE THERE IS ROOM FOR IMPROVEMENT IN SECTION 530, ESPECIALLY THAT PORTION WHICH PREVENTS THE IRS FROM PUBLISHING GUIDANCE ON EMPLOYEE/INDEPENDENT CONTRACTOR STATUS THROUGH REGULATIONS OR RULINGS. CONGRESS SHOULD START HERE TO CRAFT A LEGISLATIVE SOLUTION AIMED AT THE HEART OF THE PROBLEM, WHICH IS CLARIFYING WORKER CLASSIFICATION.

AS STATED EARLIER, THE ISSUE OF WORKER MISCLASSIFICATION CONTINUES TO CROP UP IN CONGRESS. ALTHOUGH TODAY'S HEARING DOES NOT CALL FOR SPECIFIC WAYS TO REVAMP THE SYSTEM, ABC HAS RECOMMENDATIONS FOR CERTAIN AREAS WE BELIEVE CAN BE IMPROVED UPON

FOR INSTANCE, THE CURRENT IRS TEST USING 20 COMMON LAW FACTORS TO DETERMINE WORKER CLASSIFICATION LEAVES TOO MUCH ROOM FOR GUESSWORK. THE VAGUE GUIDELINES AND THEIR INCONSISTENT APPLICATION CONTRIBUTE TO THE CONFUSION. IF CONGRESS OR THE IRS IS SERIOUS ABOUT CRACKING DOWN ON ABUSE, INSTEAD OF TAKING A SWIPE AT A SINGLE INDUSTRY GROUP, WE SUGGEST ANOTHER APPROACH. ABC BELIEVES THAT CONGRESS AND THE IRS NEED TO DO THE FOLLOWING THREE THINGS: 1) RECOGNIZE THE VALIDITY OF INDEPENDENT CONTRACTORS IN CERTAIN SECTORS OF THE WORKPLACE; 2) PROVIDE WORKABLE DEFINITIONS AND A SET OF RULES TO DISTINGUISH INDEPENDENT CONTRACTORS FROM EMPLOYEES; 3) ENFORCE THEM ACROSS THE BOARD.

ABC WELCOMES THE OPPORTUNITY TO WORK WITH MEMBERS OF THE COMMITTEE AND OTHERS IN CONGRESS CONCERNED ABOUT INDEPENDENT CONTRACTORS. WE URGE YOU TO OPPOSE THIS PARTICULAR PROVISION, THOUGH, IN LIGHT OF THE DETRIMENTAL EFFECTS IT WILL HAVE ON CONSTRUCTION EMPLOYERS AND ITS FAILURE TO ACCOMPLISH INCREASED COMPLIANCE.

THANK YOU FOR YOUR CONSIDERATION.

Chairman **Rangel**. Thank you. All of the witnesses' entire written statements will be entered into the record, without objection. We will now hear from Mr. Desjardins.

STATEMENT OF ROBERT J. DESJARDINS, EXECUTIVE VICE PRESIDENT AND TREASURER, CIANBRO CORP., PITTSFIELD, MAINE, AND CHAIRMAN, TAX AND FISCAL AFFAIRS COMMITTEE, ASSOCIATED GENERAL CONTRACTORS OF AMERICA

Mr. **Desjardins**. Good afternoon, Mr. Chairman. I am Robert Desjardins, the executive vice president and treasurer of Cianbro Corporation of Pittsfield, Maine. We are one of the larger construction companies building projects in the Northeast and MidAtlantic States. I also serve as chairman of the Tax and Fiscal Affairs Committee of the Associated General Contractors of America and am before you today in that capacity.

My testimony will be limited to the provision discussed at the beginning of this hearing by Congressmen Kleczka, Shays and Lantos. They advocate the repeal of the safe harbors under section 530 of the Revenue Act of 1978 solely for construction industry employers. I am here today to tell the other side of that story.

AGC strongly supports the safe harbor protections for individuals who work as independent contractors. We feel that singling out one industry, as this provision attempts to do, does nothing to resolve the problem of worker misclassification.

Worker misclassification is an old issue for the IRS and for the employer. It has been the subject of numerous hearings in this committee and other congressional committees, extensive litigation, as well as the topic of a 1992 GAO report; yet the issue remains unresolved.

The provision before us today seeks to change one aspect of this contentious and problematic issue, but does nothing to help solve it. AGC believes that repealing the section 530 safe harbor for construction industry employers would further complicate the employer-worker relationship and strip away the only protection general contractors have in dealing fairly with the IRS.

Let me describe for you a history of section 530 and why this provision is a step in the wrong direction. A variety of occupational relationships and job classifications exist in the American workplace and particularly in the construction industry. However, for Federal tax purposes, only two classifications exist. A worker is either an employee or is an independent contractor; that is, self-employed. Significant tax consequences result from how a worker is classified. Some of the tax consequences favor employee status while others favor independent contractor status.

Section 530 exists because Congress realized that independent contractors contribute a vast amount of added value to economic production and because it is not fair to change the rules after taxpayers organize their affairs according to good faith reliance on industry practice or prior IRS determinations. Congress enacted these protections for a number of reasons, but it is safe to say the legislative history of section 530 supports the view that taxpayers ought to be afforded wide latitude in asserting or maintaining independent contractor status.

Specifically, these protections were established because individuals not under the control of others in the workplace bear all the risk and expense for their employment. They were increasingly vulnerable to IRS reclassification as employees subsequent to prior audits in which their treatment as independent contractors had not been challenged and after private letter rulings or technical advice memoranda from the Service had said that they were independent or after they had relied on common industry practice.

In its original explanation of section 530 in the Revenue Act of 1978, the Joint Committee on Taxation stated that section 530 was enacted to protect certain classes of taxpayers from IRS reclassification of independent contractors as employees. The general explanation says, "Workers shall be deemed not to be the taxpayer's employees, unless the taxpayers had no reasonable basis for not treating the workers as employees."

The Joint Committee on Taxation further explained that the Revenue Act of 1978 terminated pre-1979 employment tax liabilities of taxpayers who had a reasonable basis for treating workers other than as employees. Clearly the legislative history of this provision establishes that Congress acknowledged that certain taxpayers have a legitimate basis for using workers not considered as traditional employees.

This "reasonable basis" standard has been the guiding principle behind worker classification since 1979. If there is any confusion about Congress' intent with regard to the issue of classification, any ambiguity is removed by the statement in the general explanation "that Congress intends that this reasonable basis requirement be construed liberally in favor of taxpayers."

In other words, Congress intends that taxpayers, including general contractors, who use independent contractors, are to be afforded the benefit of the doubt. This presumption in favor of the taxpayer is initially accomplished through the creation of three statutory reasonable basis standards, or safe harbors.

The first safe harbor is reached if the taxpayer's treatment of an individual as not being an employee is due to reasonable reliance on judicial precedent, published rulings, or previous technical advice from the IRS.

The second safe harbor is attained if the taxpayer shows reasonable reliance on a past IRS audit.

The third, and perhaps most significant safe harbor from the viewpoint of the construction industry, is that the taxpayer relies on a longstanding, recognized practice of a significant segment of the industry in which the taxpayer is engaged. There is no requirement that the recognized practice be uniformly followed throughout an entire industry.

For example, consider a situation common to thousands of construction sites throughout the country. Individuals contract for short periods with one or more construction companies to perform certain work on construction projects. These individuals own their own trucks. They own their own tools and may even pay into their own retirement plans. They are not told when to report to work or how to perform the work. And other contractors in the general geographic region are free to contract with these individuals or others like them to perform the same type of short-term work.

By any objective standards, these individuals are not employees of the general contractor, but without the protection of section 530, the Federal Government may determine that they are, even after both parties have relied on historic industry practice or on prior IRS advice. If the government successfully prevails in a reclassification case against the independent contractor, that individual is then subject to withholding, Social Security and unemployment taxes, none of which have been withheld, nor paid to the Treasury.

Congressman Kleczka's provision evolves from the misconception that the construction industry has greatly abused section 530 safe harbors through intentional worker misclassification and that this abuse is far greater than in any other industry. This perception is wrong. There is simply no empirical evidence that general contractors engage in willful, systematic evasion of the law.

In fact, former Treasury Assistant Secretary for Tax Policy Fred Goldberg testified that most noncompliance is unintentional. The Tax Code is far too complex. The vast majority of general contractors follow the law and make good faith efforts to meet the requirements of the code even when they do not fully understand every provision. Taking section 530 safe harbors away from the construction industry is excessive, unnecessary and would further aggravate an industry experiencing an unemployment rate consistently twice the national average.

Before Congress repeals section 530 of the Revenue Act of 1978 solely with respect to the construction industry or for any other industry, the IRS must first augment and strengthen its management of existing programs with respect to worker classification.

With regard to those few who intentionally violate the law, our position is clear, consistent and simple. Don't do it. If you do, you should bear the full consequences of the law.

AGC looks forward to working with the Committee on Ways and Means and with Congress to resolve the complex and important issues relating to the proper classification of workers. This provision however goes too far and would harm the construction industry. We ask you, Mr. Chairman, to refrain from adding it to the many other provisions that may ultimately be included in the legislation passed by the committee.

Thank you for your time today. I would be pleased to answer any questions.

Chairman RANGEL. Thank you.

[The prepared statement follows:]

TESTIMONY OF ROBERT J. DESJARDINS
THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

Good Afternoon. My name is Robert J. Desjardins and I am the Executive Vice President and Treasurer of Cianbro Corporation of Pittsfield, Maine. Our company is one of the larger construction companies building projects in the Northeast and Mid-Atlantic states. I also serve as Chairman of the Tax and Fiscal Affairs Committee of the Associated General Contractors of America and I am before you today in that capacity.

The Associated General Contractors of America (AGC) is a national trade association comprised of more than 33,000 firms, including 8,000 of America's leading general contracting companies. They are engaged in the construction of the nation's commercial buildings, shopping centers, factories, warehouses, highways, bridges, tunnels, airports, water works facilities, multi-family housing projects and site preparation/utilities installation for housing development. Many AGC member firms routinely contract with independent contractors to perform work in many different states and localities, helping to add to the value of vigorous competition on construction projects in these markets.

On behalf of AGC, I welcome the opportunity to testify on the need to retain Section 530 of the Revenue Act of 1978 for the construction industry. The provision before the committee today would repeal that safe harbor specifically for construction industry employers. AGC strongly supports the safe harbor protections for individuals who work as independent contractors. We feel that singling out one industry, as this provision attempts to do, does nothing to resolve the problem of worker misclassification.

Background

Worker misclassification is an old issue both for the IRS and employers. It has been the subject of numerous hearings in this committee and other Congressional committees, extensive litigation, as well as the topic of a 1992 GAO report (GAO/GGD-92-108, July 23, 1992; Tax Administration: Approaches to Improve Independent Contractor Compliance). Yet, the issue remains unresolved.

A variety of occupational relationships and job classifications exist in the American workplace and in the construction industry. However, for Federal tax purposes only two classifications exist: a worker is either an employee or an independent contractor (i.e. self-employed). Significant tax consequences result from how a worker is classified; some of the tax consequences favor employee status, while others favor independent contractor status.

Section 530 exists because Congress realized that independent contractors contribute a vast amount of added value to economic production and because it is not fair to change the rules after taxpayers organize their affairs according to good faith reliance on industry practice or prior IRS determinations. Congress enacted these protections for a number of reasons, but it is safe to say the legislative history of Section 530 supports the view that taxpayers are to be afforded wide latitude in asserting or maintaining independent contractor status.

Specifically, these protections were established because: individuals not under the control of others in the workplace bear all the risk and expense for their employment; they were increasingly vulnerable to IRS reclassification as employees subsequent to prior audits in which their treatment as independent contractors had not been challenged and after private letter rulings or technical advice memoranda from the Service had said that they were independent contractors; or after they had relied on common industry practice.

Section 530 Protections

In its original General Explanation of Section 530 in the Revenue Act of 1978, the Joint Committee on Taxation stated that Section 530 was enacted to protect certain classes of taxpayers from IRS reclassification of independent contractors as employees. The General Explanation says, "workers shall be deemed not to be the taxpayer's employees, unless the taxpayers had no reasonable basis for not treating the workers as employees."

The Joint Committee on Taxation further explained that the Revenue Act of 1978 terminated pre-1979 employment tax liabilities of taxpayers who had a reasonable basis for treating workers other than as employees. Clearly, the legislative history of this provision establishes that Congress acknowledged that certain taxpayers have a legitimate basis for using workers not considered as traditional employees.

This "reasonable basis" standard has been the guiding principle behind worker classification since 1979. If there is any confusion about Congress' intent with regard to the issue of classification, any ambiguity is removed by the statement in the General Explanation that "Congress intends that this reasonable basis requirement be construed liberally in favor of taxpayers."

In other words, Congress intends that taxpayers (including general contractors) who use independent contractors are to be afforded the benefit of the doubt. This presumption in favor of the taxpayer is initially accomplished through the creation of three statutory reasonable basis standards, or safe harbors.

The first safe harbor is reached if a taxpayer's treatment of an individual as not being an employee is due to reasonable reliance on judicial precedent, published rulings, or previous technical advice from the IRS.

The second safe harbor is attained if the taxpayer shows reasonable reliance on a past IRS audit.

The third, and perhaps most significant safe harbor from the viewpoint of the construction industry, is that the taxpayer relies on a long-standing, recognized practice of a significant segment of the industry in which the taxpayer is engaged. There is no requirement that the recognized practice be uniformly followed throughout an entire industry.

For Example

Consider a situation common to thousands of construction sites throughout the country. Individuals contract for short periods with one or more construction companies to perform certain work on construction projects. These individuals own their own trucks. They own their own tools. They pay into their own retirement plans. They are not told when to report to work, or how to perform the work. And other contractors in the general geographic region are free to contract with these individuals, or others like them, to perform the same type of short term work.

By any objective standard, these individuals are not employees of the general contractor. But without the protection of Section 530, the Federal government may determine that they are, even after both parties had relied on historic industry practice or on prior IRS advice. If the government successfully prevails in a reclassification case against the independent contractor, that individual is then subject to withholding, social security and unemployment taxes--none of which had been withheld nor paid to the Treasury.

Conclusion

The provision evolves from the misconception that the construction industry has greatly abused Section 530 safe harbors through intentional worker misclassification and that this abuse is far greater than in any other industry. This perception is wrong. There is simply no empirical evidence that general contractors engage in willful, systematic evasion of the law.

In fact, former Treasury Assistant Secretary for Tax Policy Fred Goldberg testified that most non-compliance is unintentional. The tax code is far too complex. The vast majority of general contractors follow the law, and make good faith efforts to meet the requirements of the Code, even when they do not fully understand every provision. Taking the Section 530 safe harbors away from the construction industry is excessive, unnecessary and would further aggravate an industry experiencing an unemployment rate consistently twice the national average.

Before Congress repeals Section 530 of the Revenue Act of 1978 solely with respect to the construction industry, or for any other industry, the Internal Revenue Service must first augment and strengthen its management of existing programs with respect to worker classification.

With regard to those few who intentionally violate the law, our position is clear, consistent and simple: Don't do it! If you do, you should bear the full consequences of the law.

AGC looks forward to working with the Committee on Ways and Means and with Congress to resolve the complex and important issues relating to the proper classification of workers. This provision, however, goes too far and would harm the construction industry. We ask you Mr. Chairman, to refrain from adding it to the many other provisions that may ultimately be included in legislation passed by the Committee.

Thank you.

Chairman RANGEL. Mr. Herr.

STATEMENT OF GERARD J. HERR, ASSISTANT TREASURER, BRYN AWEL CORP., BALTIMORE, MD., AND VICE CHAIRMAN, WASHINGTON INTEREST PROGRAM COMMITTEE, CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION

Mr. HERR. Good afternoon, Mr. Chairman. My name is Gerard Herr. I am a certified public accountant and assistant treasurer of the Bryn Awel Corp., a Baltimore-based asphalt manufacturer and highway construction firm. Bryn Awel operates as a general contractor as well as a subcontractor on both private and public work.

I also am vice chairman of the Washington Interest Program Committee of the Construction Financial Management Association, CFMA. It is in this capacity that I am here today. CFMA represents more than 5,000 financial managers in the construction business.

Our members are employed by over 2,000 construction companies across the United States. More than one-third have gross annual revenues ranging from $25 million to $99 million. CFMA members consist of general contractors, subcontractors, utility contractors and highway contractors, among others.

On behalf of CFMA, I thank you for this opportunity to testify on an issue important not only to our members, but to the entire construction industry.

We understand you face a difficult task in putting together revenue neutral legislation, but we encourage you to approach the independent contractor issue carefully.

CFMA strongly opposes the proposal to repeal the section 530 safe harbor for classifying construction workers as independent contractors.

Section 530 was adopted to simplify an otherwise confusing area of tax law for many taxpayers. It has worked. Removing the safe harbor will hurt the construction industry and will reinstate the confusion and controversy surrounding this issue in the 1960s and 1970s.

It also will increase the administrative burden on the industry of complying with the tax laws. Additionally, eliminating section 530 for the construction industry but not for other taxpayers runs counter to a basic tenet of tax policy that requires treating similarly situated taxpayers the same.

Singling out construction companies punishes a group that historically has led this country in economic growth and in economic recovery from bad times. Given the current slow growth of our economy, CFMA questions the wisdom of any acts that could impede economic growth.

Congress adopted section 530 as a stopgap measure to buy time to produce a permanent solution to this complex and controversial issue. Eliminating section 530 without enacting a replacement ignores this history of controversy and complexity. If Congress approves this proposal, we will be right back where we were in 1978.

Section 530 was enacted because the rules for classifying a worker as an employee or as an independent contractor are confusing and subjective. The rules basically require contractors to consider 20 factors to determine if a worker is controlled by an employer.

On paper, the 20 factors may look reasonable. In reality, they can be a nightmare.

It is important that Congress understand industry practice within the construction industry before changing the rules that apply to us. Although the statutory safe harbor of section 530 generally is available to all taxpayers, in fact that availability depends on several factors. One of those factors is longstanding industry practice. Owners, contractors and subcontractors now know that if they rely on industry practice, they can establish an independent contract or relationship that will be accepted by the IRS.

Within the construction industry, longstanding industry practice includes the general subcontractor and subcontractor-subcontractor relationships. Additionally, specialty trade contractors are hired on a project-by-project basis for short durations and certain assignments.

These contracts can include lump-sum, fixed-fee, cost-plus, time-and-material or labor-only agreements. The construction industry has relied on the contractor-subcontractor relationship so the general contractor does not have to hire the various trade specialists as employees.

Removing the safe harbor would threaten this longstanding industry practice of subcontracting. Consequently, it would threaten the ordinary way of doing business for smaller contractors, especially sole proprietors.

If section 530 is not available, the Internal Revenue Service could attempt to recharacterize legitimate independent contractors as employees, clearly producing uncertainty and confusion for the industry. To avoid such a result, industry practice would have to be changed and before those practices can be changed, many general contractors will find that in the eyes of the Internal Revenue Service, they are not general contractors but employers.

I have included in my written statement several examples of subcontractor situations that could be misconstrued by IRS agents as employer-employee relationships. I will not mention all of them, but I think you might find some examples useful.

For example, I can see how the IRS might recharacterize an independent contractor as an employee in the following cases: punch list cleanup work where many miscellaneous corrections are required; contracts which include installation only with materials supplied separately, for example an HVAC subcontractor who installs a central air-conditioning system; remodeling work where hidden site conditions are unknown, and therefore the extent of the work is not determined in advance; constructing clean rooms for manufacturing of computer chips. In clean-room construction, it is common industry practice for general contractors to provide cleanliness training for all workers, including the subcontractor's workers, to ensure that the clean rooms meet contract requirements.

Mr. Chairman, CFMA feels strongly that it would be irresponsible for Congress to repeal section 530 for the construction industry, for any other industry, or completely, without first considering the result. The result of course would be to send a message to the construction industry that we can no longer rely on the longstanding industry practice of contracting and to throw the industry into the 20 factor test. That would be an unfair result.

CFMA welcomes the opportunity to work with members of the committee and others in Congress with regard to independent contractors.

In closing, I would like to address a question raised this morning regarding the assurance that employees of subcontractors are paid their full pay and benefits. The question was asked of the gentleman from the National Association of Home Builders. A reply to that question is that on all public works which are Davis-Bacon projects, we are required either as general contractors or subcontractors to submit to the local or State government or Federal Government weekly certified wage reports that show what rates were paid, and that benefits, union dues, FICA and FUTA taxes are paid for those employees covered by that project.

These reports are signed off by an officer of the company whether at the subcontractor or the general contractor level. That is a means of guaranteeing that proper wages are being paid to subcontractor employees.

Chairman RANGEL. Are you suggesting that be done for jobs that are not under Davis-Bacon. That is a possible solution to the problem.

Mr. HERR. As a possible solution, yes. However, I can also add, Mr. Chairman, that on most of the private sector work that we perform, most of our customers already require us to provide signed releases not only from our company as a general contractor, but also from each subcontractor. The releases state that employees have been paid, unions have been paid their dues, and suppliers and second tier contractors have been paid in full. These releases are required in most cases before our private sector customers will pay us for the job.

[The prepared statement follows:]

Testimony of Gerard J. Herr
Assistant Treasurer, Bryn Awel Corporation
Representing the Construction Financial Management Association
before the Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives

September 21, 1993

Good afternoon. My name is Gerard J. Herr and I am a C.P.A. and the Assistant Treasurer of the Bryn Awel Corporation, an asphalt manufacturer and highway construction firm with annual revenues in excess of $50 million. Bryn Awel is located in Baltimore, Maryland and we build projects in Maryland, Washington, D.C. and Northern Virginia. We operate as a general contractor as well as a subcontractor on both private and public works. I also am Vice Chairman of the Washington Interest Program Committee of the Construction Financial Management Association and it is in this capacity that I am before you today.

The Construction Financial Management Association (CFMA) was established in 1981 and represents more than 5,000 financial managers in the construction business. CFMA members are employed by over 2,000 construction companies across the U.S., more than one-third of which have gross annual revenues ranging from $25 - 99 million.

On behalf of CFMA, I would like to thank you for the opportunity to appear before the subcommittee on an issue important not only to our members but to all members of the construction industry. We understand the difficult task this subcommittee and Congress face in putting together revenue neutral legislation. And we can understand that you expect to find opponents for provisions that raise revenue as easily as you find supporters for provisions that lose revenue. But we encourage this subcommittee to approach the independent contractor issue carefully.

Because CFMA is an association of financial managers, it cuts across industry lines and represents all segments of the industry, including general contractors and subcontractors. And it is the long-standing industry practice of general-subcontractor and subcontractor-subcontractor relationships that we will be discussing today.

I. CFMA POSITION ON SECTION 530 AND ITS EFFECT ON THE INDUSTRY

There is no question that removing the safe harbor of section 530 will hurt the construction industry. Such action will reinstate the confusion and controversy between the industry and the IRS that existed in the 1970s. And it will increase the administrative burden on the industry of complying with the tax laws. For these reasons, we strongly oppose the proposal to repeal the safe harbor under section 530 relating to the classification of workers as independent contractors for members of the construction industry.

Section 530 was adopted to simplify an otherwise confusing area of tax law for many taxpayers. It has worked. It should not be revised if the result is to increase the administrative burden on taxpayers rather than to alleviate that burden. Without section 530, many of our members would face the tasks of insuring first that they accurately classify employees as "employees" and independent contractors as "independent contractors" and second that nothing they subsequently do jeopardizes those classifications. Time and resources spent on this tax classification issue would be time and resources not available for work.

Additionally, eliminating section 530 for the construction industry, but not for other taxpayers, runs counter to a basic tenet of good tax policy that requires treating similarly situated taxpayers similarly. By singling out the construction industry, this proposal also punishes a sector of the economy that historically has led this country in economic growth and economic recovery from bad times.

The construction industry historically has played an important role in creating well-paying jobs for our economy. Denying section 530 treatment to the industry almost certainly will eliminate some of those jobs; it also could seriously jeopardize the ability of many contractors to remain in business. Given the current slow-growth of the U.S. economy, CFMA questions the wisdom of unnecessary acts that could impede economic growth.

II. BACKGROUND ON 530

Congress adopted Section 530 of the Revenue Act of 1978 because the rules on the classification of workers as "employees" or "independent contractors" were imprecise. For years before section 530 was enacted, the IRS increased its employment tax audits -- leading to increased controversies between the IRS and businesses. Section 530 was a stopgap measure to give Congress time to produce a permanent solution to the complexity of the independent contractor issue that would eliminate this source of controversy. Congress has made some progress on the issue. But Congress evidently also has learned the lesson learned earlier by business and IRS: this is a hard problem to solve.

Congress acted on the issue in 1982. Statutory standards were adopted for two types of workers; if the standards are met, the workers (direct sellers and real estate agents) will be treated as independent contractors. But Congress also decided -- as part of the same 1982 legislation -- to extend section 530 for everyone else. Clearly the decision was to simplify and clarify the law where possible -- for direct sellers and real estate agents -- and to leave everyone else as is. Consequently, section 530 was indefinitely extended to give Congress time to produce legislation on the classification of workers as independent contractors or employees without reigniting controversy with the IRS over the classification issue. Congressional actions in 1978 and in 1982 clearly indicate that section 530 was intended to help taxpayers. Eliminating section 530 without enacting a replacement ignores the history of controversy and complexity that surrounds the independent contractor issue.

If the provision is eliminated -- whether for the construction industry or for all taxpayers -- Congress first should determine if the problems that led to its enactment still exist. In CFMA's opinion, those problems still exist. Eliminating section 530 may raise revenue for Treasury. And it may help members of the construction industry who choose to operate with employees rather than with independent contractors. But it does so without consideration of the history of the issue or the effects on a large segment of the construction industry. If Congress approves this proposal, we are going to be right back where we were in 1978.

III. LIFE WITHOUT SECTION 530

Section 530 was enacted 15 years ago because the rules for classifying a worker as an employee or as an independent contractor are confusing and subjective. Those rules basically require considering 20 factors developed by the IRS from court decisions which determine if a worker is controlled by an employer. On paper, the 20 factors may look reasonable. In reality, they can be a nightmare. It is important that Congress understand industry practice within the construction industry before changing the rules that apply to us.

Although the statutory "safe harbor" of section 530 generally is available to all industries or businesses, it is dependent upon several factors, including long-standing industry practice. Owners, contractors, and subcontractors now know that if they rely on industry practices they can establish an independent contractor relationship that will be accepted by the IRS.

Within the construction industry, long-standing industry practice includes the general-subcontractor and subcontractor-subcontractor relationships that have always been the norm for doing business. Additionally, specialty trade contractors are hired on a project basis for short durations under various contract forms to complete certain assignments. Some of these contracts can include lump-sum, fixed-fee, cost-plus, time and material, or labor-only agreements. Contractors can be selected on a competitive bid or negotiated basis depending upon the assignment.

The industry has always relied upon the existence of a contractor-subcontractor relationship to carry out construction so the general contractor does not have to hire all the various trade specialists as employees. To remove the "safe harbor" would threaten the longstanding industry practice of subcontracting and would threaten the ordinary way of doing business for smaller contractors and, especially, sole proprietors.

If section 530 is not available for the construction industry, the IRS could attempt to recharacterize legitimate independent contractors as employees clearly producing uncertainty and confusion for the industry. To avoid such a result, industry practice would have to be changed. And, before those practices can be changed, many general contractors will find that -- in the eyes of the IRS -- they are not general contractors but employers.

For example, in construction management it is longstanding industry practice for an owner to contract directly with a general contractor who will manage a project and enter contracts with trade specialists and other independent contractors. However, it also is common industry practice for an owner to contract directly with a general contractor and with trade specialists and other independent contractors. In both cases, under industry practice, the general contractors and the subcontractors are independent contractors.

But, if section 530 is repealed, it is all but certain that some IRS agents will decide that owners who contract directly with subcontractors are employers under the 20 factor test. Consequently, owners, general contractors, and subcontractors will face the situation where they can no longer feel confident when they have issued a contract or work order that the IRS will agree that is what they are dealing with.

Several examples of subcontractor situations that could be misconstrued by IRS agents as employer-employee relationships are:

- Punch list clean-up where many miscellaneous corrections are required in the work.
- Contracts which include installation only with materials supplied separately, e.g. HVAC subcontractor to install a central air conditioning system.
- Remodeling work where hidden site conditions are unknown and therefore the extent of the work is not determined in advance.

We thought it may be helpful for the Committee to see how these 20 factors -- in the absence of the section 530 safe harbor -- might be used to recharacterize a traditional contractor relationship as an employer-employee relationship. Not all of the 20 factors have to be met to find the employer-employee relationship, so contractors will be faced with the possibility of having to continually defend doing business with subcontractors.

Examples of how the 20 factors could be interpreted by IRS to question the existence of subcontractor relationships and to find an employer-employee relationship are as follows:

1. Instructions -- The general contractor has the overall responsibility for safety and management of the jobsite and will direct subcontractors when they can work and the safety rules to be followed on the project.

2. Training -- Certain work may be very technical or complicated, which could result in the general contractor providing training for subcontractor workers regarding materials handling, installation, safety, etc. For example, in the construction of "clean rooms" for manufacturing wafers and computer chips, it is common industry practice for the general contractor to provide "cleanliness training" for all workers -- including the subcontractors' workers -- to insure that the "clean rooms" meet contract requirements.

3. Integration -- The general contractor will provide the schedule of access and completion times and coordinate work of other specialty contractors to minimize interference and increase productivity.

4. Service Performed Personally -- A subcontractor's principal may also perform a portion of the work, especially if it is a sole proprietor or a small contractor.

5. Hiring, Supervising, and Paying Assistants -- It would not be unusual to closely supervise and direct workers of a subcontractor who are in the process of correcting punch list items.

6. Continuing Relationship -- A pattern of repeat business with the same general contractor could be read as a continuing employer-employee relationship.

7. Set Hours of Work -- The general contractor controls access to the project and therefore sets hours of work.

8. Full Time Required -- The general contractor monitors the progress of work and can force staffing changes to keep the work on schedule.

9. Doing Work on Employer's Premises -- By necessity, the work location is established and controlled by the general contractor since it must be done at the job.

10. Order or Sequence Set -- The general contractor is responsible for scheduling and coordinating subcontractors and therefore sets the order of work to enable the project to be completed on time.

11. Oral or Written Reports -- The general contractor requires regular reports from the subcontractors on the progress of the work in order to continually update the completion schedule and coordinate other trades.

12. Payment by Hour, Week, Month -- Usually a contract is done on a lump-sum basis but can be on a per unit, hourly or cost-plus basis. Anything other than lump sum could be suspected of representing an employee situation.

13. Payment of Business and Traveling Expenses -- This is usually not a factor, but if it should be, it is possible that reimbursement of these expenses would be provided for in the agreement.

14. Furnished Tools and Materials -- Most subcontractors supply their own tools, but it would not be unusual for the general contractor to supply materials purchased separately from the subcontract agreement.

15. Significant Investment -- Many contractors can maintain a business with little investment by working out of their homes or minimal rented space and using rented tools and machinery.

16. Realization of Profit or Loss -- Independent contractors will most likely have the exposure but may have a cost-plus contract which could isolate them from most exposure to loss.

17. Working for More than One Firm at a Time -- Small contractors may not have the capacity to do this but will have multiple contracts to be done on a rotating basis.

18. Making Service Available to the General Public - Independent contractors may be available to do work for general contractors but not necessarily for the general public.

19. Right to Discharge -- Owner contracts typically contain language that gives them the right to discharge any workers they find objectionable. The same right is given to the general contractor.

20. Right to Terminate -- A subcontractor under certain contracts can terminate a relationship, providing proper notice is given.

These examples show that there could be many situations which could be falsely read as employer-employee relationships, resulting in the assessment of inappropriate penalties, interest and taxes. The construction industry today does business as it always has by subcontracting work. This is the reason that long-standing industry practice is relied on by law and the courts, not only for the construction industry but for all industries.

It would be irresponsible for Congress to repeal section 530 for the construction industry, any other group, or completely without also considering the result. The result, of course, would be to throw the affected taxpayers into the 20 factor test. Given the industry's past practice of classifying workers as employees or independent contractors, this would be an unfair result. Better to revise the 20 factors before dropping section 530.

Chairman RANGEL. Ms. Sumner.

STATEMENT OF SALLY SUMNER, R.N., CHAIRPERSON, BOARD OF DIRECTORS, NURSE BROKERS & CONTRACTORS OF AMERICA

Ms. SUMNER. Good afternoon, Mr. Chairman.

It may seem unusual for an organization representing health care professionals to be testifying on a matter that affects the construction industry. But to NBCA, the issue here is far more broad.

First, section 530 provides the necessary employment tax safe haven against arbitrary IRS enforcement of an unpredictable common law employment test.

NBCA members have firsthand experience of the importance of section 530 in the nursing profession, as I will explain.

Second, there is no compelling reason to single out, by repealing an important law like section 530, the construction industry. Indeed, government data show that tax compliance in that industry is as good as many others. Thus action against the construction industry will only serve to encourage further legislative action to repeal section 530 for others.

Third, NBCA recognizes the only industry currently denied section 530 protection is the technical services industry which is the result of section 1706 of the 1986 Tax Reform Act. NBCA believes that instead of repealing section 530 for the construction industry, Congress should repeal section 1706 and eliminate a discriminatory and unfair law against the technical services industry that is apparently serving as legislative precedent for selectively targeting other industries.

Fourth, NBCA believes that Congress should enact a version of the 1992 bill H.R. 5011 if it is really serious about correcting problems associated with the use of independent contractors by firms which encourage tax cheating.

I will touch upon two of these points in my continued oral testimony.

Mr. Chairman, section 530 is extremely important to registered nurses who work as independent contractors and to their broker firms. In 1984, my business was audited by the IRS. The IRS field agent determined that my business owed $22,000 in back taxes plus interest and penalties on the grounds that the nurses working through us were our employees. It did not matter to the IRS if the nurses themselves had already paid these taxes in full.

Over the next 7 years, we fought the IRS and finally in 1991 a jury found in our favor, but it cost us over $200,000 in legal fees to defeat that assessment.

Although we were confident of our position on the common law factors, the jury decided the case on the reasonable basis theory in section 530. Judge Broderick's charge to the jury asked whether we had a reasonable common law basis under section 530. He upheld the jury's verdict that we had such a basis. No company should have to go through what we went through, whether a construction company, a computer firm, a nurse broker, or some other business.

Our case was truly one of David and Goliath. The IRS is a governmental behemoth with enormous resources while small honest businesses like ours are financially strapped on a daily operational basis. The hint of an IRS audit scares away clients, prevents expansion and growth, and consumes human and financial resources. In this environment, section 530 relief for small, honest businesses should not be diluted.

Without section 530, our business might have been destroyed and the nurses whom we serve, all of whom appear to have been law abiding taxpayers, may have been forced to give up the option of self employment. Until Congress comes up with a better definition than the common law employment test, we all need section 530.

This brings me to my second key point. For a number of years, NBCA has been in touch with organizations in the technical services industry because we wanted to see what can happen when section 530 is repealed. Not surprisingly, we learned the following: Because firms in the technical services industry are covered only by the common law employment test, they are ripe for picking by the IRS. Thus, even honest firms that have acted reasonably but erroneously in the eyes of the IRS have been forced to fight tax assessments of hundreds of thousands of dollars, despite the fact that those taxes have often already been paid by the workers themselves.

Even those taxpayers in the technical services industry who win their cases legally have really lost in light of the difficulty and cost of defending their positions without the ability to rely on section 530. I saw what happened to my own firm with section 530 relief and I am saddened by the enormous fees paid by technical services firms to fight the IRS without section 530.

We also learned of thousands of legitimate self-employed computer programmers and engineers who are effectively forced to abandon their independent contractor status even if they could prevail against an IRS reclassification, because too many firms simply do not want to invite IRS examination.

In light of the adverse impact from section 1706, how is it possible to justify this discriminatory law. Frankly, to NBCA it seems impossible to justify. Even the Treasury study of section 1706 showed that technical services workers and firms have higher than average tax compliance, even higher than construction and other industries.

We need to start making the employment tax laws more fair by getting rid of section 1706 instead of using it as a precedent to repeat the mistake by an ad hoc repeal for the construction industry. Otherwise, waiting on your doorstep will be other special interest groups that want to repeal section 530 for the nursing profession and others, even though we have excellent tax compliance.

Until Congress tackles the common law employment definition, we all need section 530 unless we want to abolish self employment.

Thank you.

Chairman RANGEL. Thank you, Ms. Sumner.

[The prepared statement follows:]

NBCA
NURSE BROKERS &
CONTRACTORS OF AMERICA

September 21, 1993

Prepared Written Statement of
Sally Sumner, R.N.
Chairperson, Board of Directors
Nurse Brokers and Contractors of America

OPENING REMARKS

Mr. Chairman, thank you for the opportunity to testify today. My name is Sally Sumner and I am a registered nurse and co-owner of Critical Care Registered Nursing, Inc. (aka Criticare), which is a nurse brokerage firm referring specialized registered nurses to hospitals for temporary, supplemental needs. I am here today in my capacity as Chairperson of the Nurse Brokers and Contractors of America (NBCA), an organization that represents over 20,000 nurse independent contractors registered with the brokers who serve them throughout the United States.

NBCA's position on the proposal to repeal Section 530 of the 1978 Revenue Act for the construction industry is quite simple:

(I) NBCA believes that Section 530 provides a necessary employment tax safe haven against the arbitrary IRS enforcement of an unpredictable common law employment test. NBCA members have first-hand experience of the importance of Section 530 in the nursing profession.

(II) NBCA believes that there is no compelling reason to single out the construction industry by repealing an important law like Section 530 for that industry.

(III) NBCA recognizes that action against the construction industry will only serve to encourage further legislative action to repeal Section 530 for others.

(IV) NBCA recognizes the only industry currently denied Section 530 protection is the technical services industry in so-called "three-party" relationships, which is the result of Section 1706 of the 1986 Tax Reform Act. There have been repeated and widespread calls for replacing Section 1706 because it is an unfair and discriminatory law which targets only one industry. NBCA believes that instead of repealing Section 530 for the construction industry, Congress should repeal Section 1706 and eliminate a discriminatory law against the technical services industry that serves as legislative precedent for selectively targeting other industries.

(V) NBCA believes that Congress should enact a version of the 1992 bill, H.R. 5011, if it really is serious about correcting problems associated with the use of independent contractors by firms which encourage tax cheating.

I would like to expand upon these points, one-by-one.

I. The Importance of Section 530

There can be little doubt about the unacceptability of the common law definition of "employee" and "employer" which exists in the Internal Revenue Code. The few who support this definition are merely interested in assuring that as many workers as possible are classified as employees. More candidly, however, even the Treasury Department has repeatedly conceded -- as it stated in its March 1991 Report to Congress on "Taxation of Technical Services Personnel: Section 1706 of the 1986 Tax Reform Act" (Treasury Study of 1706) -- that the common law tests "lack precision and predictability"; as a prior Treasury Department Assistant Secretary told Congress, "In many cases, applying the common law test in employment tax issues does not yield clear, consistent, or satisfactory answers, and reasonable persons may differ as to the correct classification." Treasury Study of 1706 at p. 59.

Because of the problems with the common law test, Congress enacted Section 530 of the 1978 Revenue Act. As you know, Section 530 states that if a business has a reasonable basis for treating workers as independent contractors instead of employees, then that business need not pay employment taxes on those workers as long as the business has issued 1099 forms to the workers and has not treated similar workers inconsistently (i.e., some as employees and some as independent contractors).

Section 530 is extremely important to registered nurses who work as independent contractors. Many NBCA member firms, including my own firm, have had personal experience with Section 530. In 1984, my business was audited by the IRS.

The IRS field agent determined that the nurses working through Critical Care were employees not independent contractors and that we owed $22,000 in back taxes plus interest and penalties. It did not matter to the IRS if the nurses themselves had already paid these taxes in full.

Over the next seven years we fought the IRS and finally, in 1991 in U.S. District Court, Philadelphia an eight person jury found that the nurses working through Critical Care were independent contractors. It cost us over $200,000 to defeat an IRS assessment of $22,000 plus interest and penalties.

While the common law questions were taken into consideration in our trial, the jury's decision revolved around the reasonable basis theory provided in Section 530. Reliance on the twenty common law questions, which are subjective and not weighted for importance, put the taxpayer at a distinct disadvantage with the IRS, while Section 530 levels the playing field. Judge Broderick in his charge to the jury in our case gave preference to the Section 530 consideration over the twenty common law questions. He believed, based on his review of the history of the law and Congressional references to "liberal interpretation", that the Congressional intent behind Section 530 was to assist honest taxpayers. Our federal court decision stated, "based on the common law questions Critical Care did have a 'reasonable basis' [under Section 530] for treating the nurses as independent contractors".

No company should have to go through what we went through. Our case was truly one of David and Goliath. The IRS as a governmental behemoth has unlimited resources while small, honest businesses -- usually the ones who benefit most from the services of independent contractors -- are financially strapped on a daily operational basis. The hint of an IRS audit scares away clients, prevents expansion and growth and consumes human and financial resources. The relief of Section 530 for small businesses should not be diluted. It is a very important safeguard for all companies working with independent contractors. The loss of this issue by Critical Care would have meant the demise of our business as well as that of the nurses we serve, all of whom, to our present knowledge, are law-abiding taxpayers.

In summary, as a member of an industry under audit by the IRS for misclassification of workers, I understand the components of corporate challenges which I must face. The IRS mission is to provide for the collection of taxes needed to furnish the government services determined by Congress. In our court case, the government's expert witness and IRS representative could not provide evidence or documentation of independent contractor nurses who did not pay income taxes or make contributions to social security. Yet, there remains an effort by business competitors, like HHSSA, to promote within the IRS the concept of wrongdoing. These competitors, which are not nurse-owned, have provided "opinions' and "recommendations" regarding nursing practice to highly placed IRS employees which have continued to be overruled by the courts, with the help of Section 530. The fact that we as business owners must continually defend this absurd position to the IRS is difficult enough. Section 530 in some cases is the easiest and most direct way for us to put these travails behind us.

II. **The Lack of a Compelling Reason to Target the Construction Industry For Section 530 Repeal**

Given the importance of Section 530 to all businesses which may face the same IRS threats encountered by NBCA member firms, we believe that there must be some compelling reason to justify repeal of Section 530 for any particular industry. We have heard nothing that would justify repeal for the entire construction industry.

We do not mean to discount the seriousness of worker misclassification in the construction industry or any industry for that matter. However, in the Treasury Study of 1706, a general industry-by-industry breakdown of worker misclassification was presented in Table 5-1 based upon IRS analyses. The construction industry was divided into "Heavy Construction" and "Other Construction". The IRS concluded that 20.2% of all Other Construction employers misclassified some workers as independent contractors. But this finding is statistically indistinguishable from the conclusion that 19.9% of all employers in the Air Transport industry misclassified workers, 19.8% of all employers in the Oil and Gas Mining industry misclassified workers, and 19.3% of all employers in the Finance, Insurance and Real Estate industries misclassified workers. On what logical or equitable basis could Congress remove Section 530 protection from the construction industry without doing the same to these other industries? Furthermore, since only 11.9% of all employers in the Heavy Construction industry misclassified workers, how could the construction industry be treated as a single industry that in its entirely is subjected to Section 530 repeal?

We also think that it is important to note that even the IRS statistics are probably inflated. We know of many instances in which the IRS insists on reclassifying at least one worker in many firms under audit -- while 99% of the workers remain as independent contractors. Rather than fight this minimal reclassification, most firms will simply agree to pay the small back taxes on this one worker. Nonetheless, this firm has now become part of the statistical category of "Firms With Misclassified Workers" in the IRS's battle against the use of independent contractors. Hence, there is reason to believe that misclassification is not as great a problem in the construction or other industries as the IRS would lead one to believe.

In short, NBCA sees no reason for singling out the construction industry for repeal of Section 530.

III. **Precedential Effect of Section 530 Repeal on Other Industries**

NBCA is concerned that if the construction industry is subjected to Section 530 repeal, it will be impossible to avoid subsequent repeal of Section 530 for other industries. As just noted, IRS studies suggest that several other industries have essentially the same level of misclassification as the construction industry -- and even more misclassification than the Heavy Construction industry. How can Congress avoid extending the repeal of Section 530 to these other industries?

NBCA knows that some large national firms in the nurse staffing business -- including those affiliated with the organization represented by one of the other witnesses on this panel -- would like to repeal Section 530 for our industry. If the construction industry loses Section 530 relief, will our industry -- despite its excellent tax compliance record -- be among the next victims?

IV. **The Enormous Unfairness Against the Technical Services Industry Resulting From Section 1706 of the 1986 Tax Reform Act's Repeal of Section 530 for That Industry**

That the construction industry is now being singled out for Congressional repeal of Section 530 should come as no surprise because of the existence of Section 1706 of the 1986 Tax Reform Act. Section 1706 repealed Section 530 for the technical services industry, at least in so-called "three-party" relationships (where there is a worker, a client-service recipient, and an "intermediary" party like a "broker"). Unless and until Section 1706 is repealed, it will serve as a precedent for arbitrary action against other industries.

For a number of years NBCA has kept track of IRS audits in the technical services industry because we wanted to see what can happen when Section 530 is repealed for an industry. Firms covered by Section 1706 are left only with the antiquated, unpredictable common law employment test when the IRS comes knocking on their doors in an audit. As a result, they are easy prey for IRS auditors. The experience of technical services firms is illuminating.

In many of these cases, we learned that the technical services firms legally prevailed against the IRS even under the common law test -- but these firms actually "lost" their cases in the real world because they have spent anywhere from $50,000 to $200,000 to prevail on appeal at the IRS. How may firms can afford to pay such legal fees and, in doing so, have they really "won"? In most of these cases, Section 530 would have allowed these firms to prevail more expeditiously and at a lower price.

In other cases involving technical services firms, the firms simply "gave up" because they had no Section 530 relief. The IRS examiners in many of those cases admitted that the firms had a reasonable number of 20 common law factors which pointed towards an independent contractor relationship, but the examiners found that it was not enough for a firm to be "reasonable": without Section 530, a "reasonable basis" for classifying workers does not count. As a result, technical services firms which acted reasonably were nonetheless assessed tens or hundreds of thousands of dollars in back taxes; as with my own situation in the Critical Care case, most if not all of these back taxes had already been paid by the workers themselves (so the IRS was actually attempting to collect the same taxes twice). Most of the technical services firms in this situation were unable to afford the fees to fight the IRS, and so they agreed to reclassify their workers as employees. It seems clear to us that in many of these cases, Section 530 would have allowed those firms which acted "reasonably" and in good faith to prevail against the IRS and avoid back tax assessments.

Therefore, we see some of the effects of Section 1706 and its repeal of Section 530:

* An entire industry has been subjected to targeted IRS audits because Congress has left the technical services industry without any employment tax safe haven. Indeed, Section 1706 clearly discriminates against the technical services industry, as every other industry enjoys an employment tax safe haven.

* Because firms in the targeted industry are subjected to a determination of their employment tax liabilities solely on the basis of the unpredictable and antiquated common law employment test, technical services firms that have acted "reasonably" -- but erroneously in the eyes of the IRS -- have been forced to fight assessments of hundreds of thousands of dollars in back taxes that have often already been paid by the workers themselves.

* Even those taxpayers in the technical services industry who "win" their cases legally have really "lost", in light of the difficulty and cost of defending their positions without the ability to rely upon Section 530.

* Thousands of legitimate self-employed computer programmers and engineers are effectively forced to abandon their independent contractor status -- even if they could prevail against an IRS reclassification -- because too many technical services firms simply do not want to invite IRS examination. I want to emphasize that we are talking about legitimate independent contractors, the ultimate small businessperson who is being hurt by the absence of Section 530 relief in the technical services industry.

In light of the adverse impact from Section 1706, how is it possible to justify this discriminatory law? Frankly, to NBCA, it seems impossible to justify. Again, looking at the Treasury Study of 1706, technical services workers come under the Services category in Table 5-1. The IRS claims that 15.4% of firms in the Services industry have misclassified workers (assuming, as noted above in our comments, that the IRS figures are not inflated). Looking solely at the private sector "industries" listed in Table 5-1 (i.e., eliminating reference to the Government as an "industry"), we see that there were 12 industries studied by the IRS, of which the Services industry is one. Of these 12 industries listed in Table 5-1, in 7 industries the percentage of employers who misclassify workers was greater than the technical services industry. In other words, Section 1706 removed Section 530 protection for the technical services industry even though firms in that industry have a better than average rate of worker classification -- indeed, 7 industries with worse worker classification problems still have Section 530 protection.

Similarly, the Treasury Study of 1706 shows in Table 5-2 that technical services workers report at least 85.1% of their taxable income, whereas all other workers in other industries report only 79.0% of their taxable income. Again, in light of these statistics, how is it possible to justify the discrimination against the technical services industry that has resulted from Section 1706?

We have focused so much on Section 1706 not to argue for extending Section 1706 by repealing Section 530 for other industries with worse tax compliance records; we would not take that position because, as we have explained in detail, our own experience is that the common law employment test is so unpredictable that every industry must have some type of back-up employment tax safe haven like Section 530. Rather, we have focused on Section 1706 because it demonstrates the problems that arise when Congress starts to single out selected industries for loss of Section 530 relief. If Congress really wants to improve the fairness of the employment tax laws, instead of repealing Section 530 for the construction industry -- or accommodating other groups that want to repeal Section 530 for the nursing profession and other industries -- Congress should repeal Section 1706 and eliminate that unfairly discriminatory law that penalizes the technical services industry. The Treasury Study of 1706 finds no basis for this discrimination and subsequent studies, including a November 1992 House Government Operations Committee Report, have called for repeal of Section 1706.

V. Concerns Relating to the Use of Independent Contractors Can Be Adequately Addressed by Enacting a Bill Like H.R. 5011

Just because NBCA supports the retention of Section 530 does not mean that we believe that other improvements cannot be made regarding the use of independent contractors. In fact, at the July 23, 1992 hearings before this Subcommittee on "Misclassification of Employees and Independent Contractors for Federal Income Tax Purposes", and at the June 8, 1993 hearings before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Government Operations Committee, NBCA officers testified in favor of a 1992 bill H.R. 5011 (the June 1993 testimony was jointly submitted by NBCA and the American Nurses Association). We will not repeat in detail here what our testimony stated, but its key points are as follows:

* Increase the penalty for non-issuance and non-filing of 1099 forms from the current $50 to a much higher level, similar to the §3509 rates (in the neighborhood of 10% of the compensation). This will serve to encourage issuance of 1099 forms. It is the non-issuance and non-filing of these forms, not the worker's status as an independent contractor, which results in losses of tax revenues.

* Decrease the penalty for unintentional misclassification of workers in cases where 1099 forms are filed from the current unreasonably high level of about 10% of compensation to 2% of compensation, with a maximum of $500 per worker. If 1099s are filed, there is no reason to penalize businesses for unintentional misclassifications.

* Make changes to Section 530 that improve this safe haven, rather than repeal it. For example:

> (a) Congress should expressly reject the IRS view of the "consistency" test (the IRS focuses mostly on job duties, rather than on the workers' relationships with the business) and instead confirm the correctness of the decision in Lambert's Nursery & Landscaping, Inc. v. U.S., 894 F.2d 154 (5th Cir. 1990) (the court stated that job

> duties are of minimal importance in determining "consistency"). NBCA believes that too many firms which want to abolish independent contractors are using the "consistency" requirement of Section 530 as an excuse; these firms claim that because they have employees, they cannot take advantage of Section 530 and use independent contractors. As Lambert's Nursery made clear, this is not the case: as long as such firms treat their employees significantly differently from how they treat their independent contractors (and assuming that they have a reasonable basis for using independent contractors), Section 530 should still be available to them. Once this is done, firms like those in HHSSA -- which claim that they unwilling to rely upon Section 530 because they use employees -- will no longer have this excuse for their attack on competitor firms which have chosen to use independent contractors.
>
> (b) Congress should revise the "prior audit" rule in Section 530 so that only prior employment tax examinations provide a safe haven. This would actually be a narrowing of Section 530, but we believe it is justified as long as Congress defined the term "audit" to include even "informal" examinations and compliance checks where the IRS actually reviews employment tax documents and records, and/or the 20 common law questions, with the taxpayer.
>
> (c) Congress should repeal Section 530(d), which is also known as Section 1706.

NBCA believes that when Section 530 is modified in the small but important ways above (and as stated in more detail in our prior testimony), then abuses complained of in regard to the use of independent contractors will disappear or become minimal.

Finally, we wish to make another key point: although firms that use employees often claim that they are competitively disadvantaged in doing so (and hence Section 530 should be repealed to put everyone on a "level playing field"), our experience has been to the contrary. Especially with the changes proposed by H.R. 5011, the arguments of Section 530 opponents will disappear (assuming that they have validity to begin with).

In our profession, nurses face a choice of working as employees for certain nursing agencies or as independent contractors through certain broker firms. When brokers attempt to attract workers as independent contractors, these brokers cannot promise priority for work assignments, in-house training, a minimum amount of pay or salary guarantees each week, payment for uniforms or nursing tools, advancement within the company, bonuses and benefits, and similar work terms with are hallmarks of employment rather than independent contractor status (costs which are subsidized by the government because employers get tax deductions for these payments). Rather, brokers offer nurses only a completely "hands-off" referral (and the obligation of paying their own employment and income taxes from the gross payments made to them) -- there is the benefit of independence, but clearly the lack of "job" security and " employee perks". If anyone believes that brokers have a competitive edge over employers in attracting workers in such situations, such belief is based upon a completely unrealistic view of how the marketplace operates. There are trade-offs to be made and, if anything, we believe that employers generally have a competitive edge over brokers. But our response is to compete in the marketplace, and not to amend the tax laws that give employers the advantages that they enjoy.

CONCLUSION

For the above reasons, we urge this Committee to reject the repeal of Section 530 for the construction industry, and to instead repeal Section 1706 and enact a version of the 1992 bill H.R. 5011.

For more information call NBCA at (202)637-9121

Chairman RANGEL. Mr. Pyles.

STATEMENT OF JAMES C. PYLES, COUNSEL, HOME HEALTH SERVICES & STAFFING ASSOCIATION

Mr. PYLES. Thank you, Mr. Chairman. I am James C. Pyles, representing the Home Health Services and Staffing Association. We appreciate the opportunity to come testify today. The association's members provide supplemental medical staff such as nurses and nurses aides to health care facilities like hospitals and nursing facilities on a temporary basis across the country. The association's members, who are both large and small businesses, employ approximately 350,000 workers nationwide in every jurisdiction in the country.

All of our companies treat those workers as employees in accordance with the consistent application of the employment tax laws by the IRS. There is simply no question about how those employees, those workers, should be treated in our industry.

The IRS rulings have been consistent. The misclassification of workers in the supplemental medical staff industry has reached epidemic proportions and continues to grow. This misclassification we believe is intentional since, according to some of the testimony we have heard on this panel, the IRS interpretation and application of employment tax laws to our industry has been consistent and well publicized. Yet the IRS's ability to curb the abuse of the misclassification is limited by section 530 as the subcommittee heard in the last hearing.

Let me be clear. We do not oppose the legitimate designation of independent contractors as specified under the 20 common law factors that appeared to be the concern of the National Association for Home Builders this morning. Our association supports the proposal to repeal section 530 for the construction industry but strongly urges the repeal of that provision for the medical staffing industry as well. We agree that there shouldn't be a piecemeal approach to this. There should be a broader remedy to this abuse.

Congressional action to curb the waste and abuse resulting from the misclassification of employees is long overdue. This abuse of the employment tax laws has been addressed in at least four prior—or three prior congressional hearings, now four hearings. Our association has repeatedly brought this waste and abuse to the attention of the IRS and Congress since 1988.

With each congressional hearing, the following facts have become more and more clear: The misclassification of employees is pervasive and serious and it is a growing problem. Misclassification costs the Federal and State governments tens of billions of dollars in lost tax revenues each year.

Section 530 exacerbates the misclassification problem both at the Federal and at the State levels because it permits employers to intentionally violate the employment tax laws with impunity. It wastes scarce administrative resources by preventing the IRS from effectively enforcing the tax laws and prohibits the IRS from clarifying the distinction between employees and independent contractors.

Misclassification of employees victimizes workers also by depriving them of unemployment compensation, workers compensation, disability insurance, quarters of coverage for Social Security and Medicare, protection under the Fair Labors Standards Act, the Occupational Safety Act—Safety and Health Act, the Americans with Disabilities Act, and even the recently enacted Family Medical Leave Act of 1993.

Misclassification also places law abiding employers at a great competitive disadvantage by permitting competitors who ignore the law to evade the employment tax withholding requirements and the overhead costs of Federal and State worker benefit and protection programs.

Finally, misclassification in the medical staffing industry creates a health quality hazard by placing nurses in critical areas of hospitals who ostensibly are not subject to anyone's supervision and control.

Thus misclassification costs the government billions of dollars, annually wastes the IRS enforcement resources, deprives workers of benefits, penalizes law abiding employers, and creates a health hazard.

The time for study and debate we believe has passed. It is time for Congress to put an end to this abuse. The noble intent behind section 530 to ensure fair application of the employment tax laws has now been perverted by those who would use the provision to gain an unfair competitive advantage in the marketplace.

Section 530, which was never intended to be permanent, has now been on the books 15 years. Those that have grown fat feeding at this trough are going to squeal if you take it away, but you have the heavy responsibility of weighing competing interests.

Accordingly, I ask the committee—subcommittee to consider the following. When you are presented with the question of how to find money to provide access to basic health insurance for 37 million uninsured Americans in this country, think about the billions of dollars going into the pockets of scofflaws because of section 530. When you consider cutting entitlement programs or a $124 billion out of the Medicare program, think of the revenue lost to misclassification.

When you explain to your constituents why Congress raised the personal and corporate income taxes, think of misclassification. Tens of billions of dollars in revenue can be generated simply by clarifying the existing employment tax laws and without adding a single tax or cutting a single program.

We agree with Congressmen Kleczka, Lantos, and Shays that the abuse of the employment tax laws should not be allowed to continue. Accordingly, we would urge you to repeal or narrow section 530. Fair and uniform enforcement of the employment tax laws is simply good public policy.

I would be glad to answer any questions.

Chairman RANGEL. Thank you.

[The prepared statement follows:]

TESTIMONY BEFORE HOUSE SUBCOMMITTEE ON SELECT REVENUE MEASURES
MISCELLANEOUS REVENUE RAISING PROPOSALS
REPEAL OF SECTION 530 OF THE REVENUE ACT OF 1978 RELATING TO THE CLASSIFICATION OF WORKERS AS INDEPENDENT CONTRACTORS

James C. Pyles
Home Health Services and Staffing Association
119 South Saint Asaph Street, #115D
Alexandria, VA 22314
(202) 466-6550

September 21, 1993

Mr. Chairman and honorable members of the Subcommittee, I am James C. Pyles, representing the Home Health Services and Staffing Association. The Association's members are national and multistate companies that provide supplemental medical staff, such as nurses and nurse's aides, to health care facilities, such as hospitals and nursing facilities. The Association's members employ between 300,000 and 400,000 workers in nearly every state in the country and treat those workers as employees under the IRS' consistent rulings and interpretations of the employment tax laws.[1]

We support the proposal to repeal the § 530 safe harbors for construction industry employees, but strongly urge that any such repeal include the medical staffing industry as well. Since at least 1988, we have repeatedly brought the abuse of the employment tax laws in the staffing industry to the attention of the IRS and Congress. Most recently, we documented those abuses in a hearing before this Subcommittee on July 23 of last year.[2]

Congress should act now to curb the waste and abuse that is resulting from the misclassification of employees. An October 1992 report of the Committee on Government Operations summarized the findings of at least three prior congressional hearings on this issue and found that:

(a) [t]he misclassification of workers as independent contractors instead of employees is a pervasive and serious problem . . .; and

(b) [e]quity and the need for increased revenue collection demand that there be improved enforcement and statutory changes to combat the growing problem of worker misclassification.[3]

The misclassification of employees results in the loss of billions of dollars in badly needed tax revenues for both the federal and state governments. The General Accounting Office reported to this Subcommittee on July 23, 1992 that $20.3 billion in unpaid taxes were attributable to self-employed workers and that "much" of that tax gap was attributable specifically to independent contractors.[4] At an April 1991 hearing before a Government Operations Subcommittee, the IRS testified that, "conservatively," billions of dollars were being lost in tax revenue each year due to the misclassification of employees.[5] Using 1984 IRS data, GAO has estimated that lost revenue from misclassification of employees amounted to at least $2.1 billion in 1992, and that estimate did not include revenues lost due to employers who fail to comply with IRS reporting requirements.[6]

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[1] Technical Advice Memorandum 9135001 (February 28, 1991), Technical Advice Memorandum 8913002 (December 1989), Technical Advice Memorandum 8913002 (December 8, 1988); Private Letter Ruling 9122020 (June 4, 1991); Revenue Ruling 75-101, 1975-1 C.B. 318.

[2] See testimony of Home Health Services and Staffing Association (July 23, 1992).

[3] "Contractor Games: Misclassifying Employees as Independent Contractors," Committee on Government Operations, H. Rep. 102-1053, 102d Cong., 2d Sess., 10 (October 16, 1992).

Further, GAO found in a 1989 study that 38% of businesses using independent contractors misclassified employees, and the IRS has found in other studies since 1989 that 90% of businesses audited had one or more misclassified workers.[7] Thus, the Government Operations Committee concluded that the available data seems to show "the tip of a potentially enormous iceberg."[8]

States have reported losing more than $50 million annually in employment taxes because of misclassification of workers.[9]

Section 530 exacerbates the misclassification problem at the federal and state level because it allows employers that have intentionally misclassified workers to avoid paying back taxes or penalties, discourages the IRS from expending scarce administrative resources to pursue misclassification cases, and prohibits the IRS from issuing rulings or regulations to clarify the definition of employees.[10] Perhaps most significantly, § 530 "illogically allows continuation of a violation of law and even permits newcomers to an industry which has established a 530 safe harbor to operate with misclassified workers."[11]

The misclassification of employees also victimizes workers by depriving them of unemployment compensation, workers compensation, disability insurance, quarters of coverage for Social Security and Medicare, and the protection of federal and state programs such as the Fair Labor Standards Act, the Occupational Safety and Health Act, the Americans with Disabilities Act, and protection from discrimination through the Equal Employment Opportunity Commission.[12] As the Government Operations Committee recognized, the loss of such benefits and protections "can be devastating in cases of illness, unemployment, and retirement."[13] As prior congressional hearings have clearly shown, workers may be compelled to take a job even though they are misclassified, and often they are unaware of the financial and legal obligations of misclassification.[14]

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[4] See "Tax Administration: Approaches for Improving Independent Contractor Compliance," GAO/GGD-92-108, 23-24 (July 23, 1992).

[5] "Contractor Games," 5.

[6] GAO Report, 24; "Contractor Games," 5-6.

[7] "Contractor Games," 6.

[8] Id.

[9] Id. at 6.

[10] Id. at 4, 5, 7, and 8.

[11] Id. at 9.

[12] Id. at 2-4.

[13] Id. at 7.

[14] Id. at 7-8.

It has further been conclusively established that employers, such as the members of HHSSA, that comply with the employment tax laws, are "placed at a great competitive disadvantage" when "illegitimate competitors" in the same industry are permitted to misclassify employees.[15] Such illegitimate competitors can thereby evade responsibility for overhead costs related to government and private benefit programs that can cost "up to 37% of wages."[16] "Adding insult to injury," according to the recent Government Operations Committee report, the failure of these employers to pay their lawful share of overhead costs increases the cost to law abiding employers of programs such as unemployment insurance and workers compensation.[17]

Further, subjecting similarly situated employers to different treatment under the employment tax laws leads to "bitterness and cynicism about our government in general and the IRS in particular."[18]

Finally, the "confusion and misunderstanding" that has resulted from the misclassification of workers and the application of § 530 generally poses a particular threat to the health and safety of patients in the medical staffing industry.[19] In order for companies to market their nurses as independent contractors, they must contend that the nurses have the sole right to control how they provide their services and that no one has the right to supervise or control how they perform those services. Supplemental staffing nurses often serve in intensive care and other critical care departments of hospitals where the supervision and integration of their services is legally and practically imperative.[20] Thus, the misclassification of supplemental staffing nurses is particularly pernicious because it jeopardizes the quality of health care.

Accordingly, we support the repeal of § 530 and urge the Subcommittee to take action to stop the widespread and growing abuse of the employment tax laws. I would be glad to answer any questions from the Subcommittee.

JCP/jhl

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[15] "Contractor Games," 2-3, 8; "Tax Administration Problems Involving Independent Contractors," Committee on Government Operations, H. Rep. 101-979, 101st Cong., 2d Sess., 6-7 (November 9, 1990).

[16] "Contractor Games," 3.

[17] Id. at 8.

[18] Id. at 9.

[19] Id. at 7.

[20] Accreditation Standards for Hospitals, Joint Commission on Accreditation of Healthcare Ogranizations, §§ NC.2-NC.5.6, SE.1-SE.4, SP.1-S.5.4 (1993); 42 C.F.R. § 482.23.

Chairman RANGEL. Ms. Sumner, are you a nurse?

Ms. SUMNER. Yes, I am.

Chairman RANGEL. And your business, you provide nursing services for clients?

Ms. SUMNER. No, we don't provide nursing services. The company, Criticare, which I co-own, provides broker services to nurses and to hospitals. We don't provide the nursing services. The professional nurses provide nursing services.

Chairman RANGEL. Well, who would your clients be?

Ms. SUMNER. We have two clients. We have a nurse client and we have an institutional client, which could be a hospital or a nursing home or other health care facility.

Chairman RANGEL. So the hospital and the nursing home would be looking for nurses' services and you broker it?

Ms. SUMNER. That is correct.

Chairman RANGEL. You don't provide nurses?

Ms. SUMNER. The nurses provide the nursing service. We provide——

Chairman RANGEL. Well, I am a hospital and I need 100 nurses and I come to you. Would you give me 100 contracts or 1 contract?

Ms. SUMNER. I am sorry. Would you repeat? I don't understand your question.

Chairman RANGEL. Would a hospital come to you and ask for *x* number of nurses? Would you be able to broker that for them?

Ms. SUMNER. All facilities ask for different things. They may ask——

Chairman RANGEL. I am asking if a hospital asks you for 100 professional registered nurses, could they ask you to broker that? I am trying to figure out what you do. If a hospital came to you and said this is Mt. Claire Mercy Hospital, I need 100 nurses, could you broker it? What would you tell them?

Ms. SUMNER. My company could not provide that service.

Chairman RANGEL. Suppose we came to you and said, "Ms. Sumner, we need 100 nurses, could you help us in any way?" What would you tell them?

Ms. SUMNER. We would evaluate the hospital's need, contact nurses who are available to us who had indicated their desire to subcontract through our company.

Chairman RANGEL. And so here I am an outstanding hospital and I have an outstanding broker and I need 100 nurses, so you are going to give me 100 contracts with nurses? How do I get the nurses?

Ms. SUMNER. You would contact my company and I would contact nurses who might want to work——

Chairman RANGEL. When I end up, I am going to have 100 nurses, right?

Ms. SUMNER. Pardon me?

Chairman RANGEL. When I end up, you are going to have for me 100 nurses, one way or the other.

Ms. SUMNER. Through my company and others, yes, you may.

Chairman RANGEL. I am only dealing with you, Ms. Sumner. Don't give me a hard time. I want to help. I need 100 nurses and I go to you and you provide the service one way or the other so when I end up back there I have 100 nurses. The contractual relationships we are not getting into except to the point that I am asking do I just sign a contract with you or do you refer to me 100 contractors and I sign 100 different contracts?

Ms. SUMNER. You sign a contract with me that says that I will look for those services for you. The nurse signs a contract with my company that says I want you to try and find me work. Now, that nurse may or may not work at that institution on a regular or consistent basis, but may work in a variety of different settings. The nurse has complete control over where, when and how they work.

Chairman RANGEL. Now, suppose your services are so good that I want this nurse for 1 year or 2 years, would I have any problem with you?

Ms. SUMNER. No, but usually the contracts are renewed on a quarterly or monthly basis and are not written for 1 year.

Chairman RANGEL. Ten years?

Ms. SUMNER. Ten years? Well, that has not happened.

Chairman RANGEL. No, but I mean, if a nurse likes——

Ms. SUMNER. But there is no reason why that could not happen, if the nurse wanted it that way.

Chairman RANGEL. Now, would I have—I would not have to pay anything as relates to Social Security, Medicare. What would the benefits be to me as the hospital in going to you?

Ms. SUMNER. The benefits have to do with the quality of the service.

Chairman RANGEL. I am assuming that your service is the best in the country, but I mean as it relates to what I have to pay that nurse. I don't have any payroll deductions I just pay you, right?

Ms. SUMNER. There is a flat fee, yes, which is competitive for all other temporary nurse firms. The difference is an independent contractor nurse earns higher fees.

Chairman RANGEL. So I don't have to worry about what the nurse has or not have. I don't have any employer responsibilities.

Ms. SUMNER. That is correct, including all the indirect costs such as tuition reimbursement, vacation/sick pay, and so forth.

Chairman RANGEL. Because I am not an employer and you are not an employer, the nurse is the employer.

Ms. SUMNER. The nurse is self-employed, that is right.

Chairman RANGEL. Self-employed.

So would it be fair to say that I would have to pay less to you than if indeed I hired—you know the prevailing wage better than I, but it is very competitive as I understand it.

Ms. SUMNER. Than what; than if you hired the nurse directly?

Chairman RANGEL. Well, there is a shortage of nurses; is that not correct?

Ms. SUMNER. Yes, that is correct.

Chairman RANGEL. So if I wanted to pay the least amount for quality service, would I do better dealing with a broker than with the individual nurses? If I just needed your advice——

Ms. SUMNER. I think it would be about the same. You know, the nurse gets the lion's share of any fees that are paid.

Chairman RANGEL. So whether or not my employee nurse—strike that, self-employed nurse—has any type of coverage at all, that would not be my concern.

Ms. SUMNER. Coverage for what?

Chairman RANGEL. For health benefits, Social Security, disability, workmen's compensation, anything that the unions make me pay.

Ms. SUMNER. Well, the nurses pay their own self-employment tax.

Chairman RANGEL. I know what they do. I am saying it would not be my worry.

Ms. SUMNER. It would not be your—that is correct.

Chairman RANGEL. And it wouldn't be your worry.

Ms. SUMNER. Well, I issue 1099s to those people, but, I mean, you are right, they are responsible for paying self-employment and income tax as any small business would.

Chairman RANGEL. It is up to the independent contractor to decide what they want and don't want.

Ms. SUMNER. That is correct.

Chairman RANGEL. Now, we got a problem with the health care bill which I am certain you more than the rest of these people have been following, I guess we have to assume that some of these and I don't know the percentage of these independent contractors whether they are nurses or whatever just, they are just trying to make it. They can't afford the luxury of health care and all those other government imposed benefits. They will just do without it until they become successful. I assume a lot of nurses just do without it. You can't make them take it, can you?

Ms. SUMNER. I can't make them take it but it has been my experience that they all have coverage, and the Clinton health bill may help self-employed persons get better health coverage.

Chairman RANGEL. Well, nurses are probably a cut above the rest of these in terms of understanding their needs since they are trained in health care, but the general national statistics have shown that these independent contractors don't take care of themselves as well as employees are taken care of by the unions and the employers.

As a matter of fact, one of the problems we have is that we are not getting those 1099s filed so we don't even know how much money is being paid out there. That is an IRS problem, but assuming that you had a broader responsibility, and even though it is challenged the government believes it does, to give coverage to everybody and to provide disability and unemployment and Social Security. We believe we got to pay for it anyway so we might as well get something out of the beneficiary, you would not know how to help your government to do that under your brokerage outfit, would you?

Ms. SUMNER. Well, it has been my experience that the nurses who work through companies like mine generally make a higher taxable income. And in fact, in our court case, the government's own expert witness did a comparison and indicated that nurses who work as independent contractors generally pay more in self-employment and income taxes.

I think that you need to file 1099s and that the compliance enforcement is up to the IRS to determine that those taxes have been paid.

Chairman RANGEL. Would any of you object if the IRS asked you to help them and if this independent contractor worked for you, you know, for most of the year, 80 percent, 90 percent of the year, that you just withhold something, some income tax so that when we catch up to those 1099s at least we would have the money.

Of course, if there was overwithdrawal, then we pay them something, but they will pay you something for withholding, so we can get our hands on that money. I mean, if they have been with you for a long time and you know them and we don't as the government, there wouldn't be any objections to that type of thinking to help you with—to help us with the independent contractors in the way you so generously help us with employees?

Mr. PYLES. Our association, the Home Health Services and Staffing Association, certainly wouldn't object to that suggestion which I think was made by GAO several times, but I don't think that addresses the whole question because our companies also assume the overhead costs of providing the employee benefits that are prescribed by various Federal and State laws.

Chairman RANGEL. That was just one step I was trying to get closer to, because a lot of people really think it is a gimmick and we know it is not, but in order to make certain that we don't lose a lot of money in taxes, you wouldn't—there wouldn't be an objection to withhold from the independent contractor, if indeed the independent contractor just—just was associated with you for so long that we needed to get that money up front like we do with employees, there wouldn't be any big objection to that?

Mr. DESJARDINS. Mr. Chairman, I think philosophically that is fine, particularly if it avoids a hassle of whether or not a worker is an independent contractor or employee. The problem we have with that in the construction industry, if we can talk about the construction industry for a minute, is on what basis do we withhold because these independent workers are not only paid for their labor, but also their materials that they furnish and the equipment that they have. So how much do you withhold?

I mean it would be unfair to withhold on materials that they furnish but we as general contractor don't know the makeup of what they are charging us. We don't know how much is——

Chairman RANGEL. You would have to find out the same way if you are a company and he was an employee. He would buy the materials. Many times I suspect, you know, you get an independent contractor to paint your house and you say I buy the paint, or how much is it with or without paint. I don't know how they do these things.

At least there is something that can be worked out, if that is the only problem. We just want you to withhold some money on what their taxable income would be, certainly on not what they need in order to perform the function. And then I want to get even further and see whether like with Davis-Bacon that you can help your government to see that these independent contractors have some type of coverage for their employees so that the government won't get stuck with these people with no coverage and no—I hate to say benefits, because I assume that—but things that the government would think that these would be beneficiaries, so it would cut back the public expenditure for people that are not covered because they have elected to be treated as independent contractors.

Mr. DESJARDINS. Mr. Chairman, I would submit that there should be no relationship on benefits whether a worker is an employee or independent contractor, particularly in the construction industry.

Chairman RANGEL. How would you handle it?

Mr. DESJARDINS. We find many of our employees are transients. We offer—we are a large company. We offer benefits like health insurance, vacation pay and retirement and so forth, benefits.

Chairman RANGEL. But you——

Mr. DESJARDINS. Many of our people don't qualify for that because they are transient workers.

Chairman RANGEL. I am talking about you don't offer that to your independent contractors, do you?

Mr. DESJARDINS. We don't know what they provide for benefits, no. What I am saying is——

Chairman RANGEL. No, no, no, no. Listen. You don't know and really you don't care. All you want is the job that is done and I am not arguing with you.

Mr. DESJARDINS. We want the work that is done quality.

Chairman RANGEL. All the business people have been talking about a level playing field. I assume that is what you want, level playing field and if I had come in, you know, paying a whole lot of benefits to employees, I may have to charge you more than my competitor here that—you know, these people work for him and he doesn't pay anything. And there are taxes they are obligated to pay. They just pay them.

So I am just asking from the government's point of view how you could help us to make certain that the independent contractor is providing benefits for his or her employees. Is that too much of a burden?

Mr. DESJARDINS. I believe it is because we aren't required to provide benefits to our employees.

Chairman RANGEL. Well, up to the requirement that you are—up to the area that you are required, you wouldn't have a problem in treating the independent and saying that is what you have to do in order to work for my firm because I make the minimum benefit requirement and if you come here, you got to sign something so I can file it with the government to say that these people are covered and they are not going to become a burden just because you elected not to give them the same benefits that I as a fairminded, equitable business person believe that as a human being and a worker they are entitled and I don't want to hire anybody that doesn't have these same high standards for the care of the laborers, only if you know these people for a long time.

I don't mean these people that just come in and do a job and then they leave and work for someone else. I mean, they have an unusual relationship with you because you are friends, you are considerate, they like you, and they have been with you for years as independents and they want the same benefits that those people who are not independents get. You could work out something, couldn't you?

Mr. DESJARDINS. Well, perhaps we could, but I think the issue is the payment of taxes and not benefits. That is where I have a problem with——

Chairman RANGEL. You don't mind the withholding of the taxes?

Mr. DESJARDINS. I think probably the withholding could be worked out. As I say, the problem I have with that is the issue of withholding on materials that the independent contractor furnishes or the equipment he uses to perform his work. That is what I have a problem with.

Chairman RANGEL. We are moving in to collect money and people have said, and they are so right, that two things you shouldn't want to see made: One is sausage meat and the other is tax law. And when this committee is mandated by the President and then by the Speaker and then by the chairman to raise some money, we raise the money and we are losing a lot of money with independent contractors.

Now, I know that is not your concern, but we are losing a lot of money, a lot of the forms aren't being filed. We don't know where the tax is that is due and owing. A lot of the people who don't work for you but have contracts with you ultimately end up as charges to the taxpayers and so—and a lot of us do believe it is cheaper to hire the independent contractor without benefits than it is to mess around with these employees with these high powered unions. But the result is that the unions sometimes play a government role in getting coverage so that we don't have to come in and give government coverage and that is what Mrs. Clinton is all about.

We have to cover those independent contractors. You know them. They work cheap, but they don't take care of themselves. They don't have a union and we take care of them. So if you can't think of ways to help us either to collect the money or to see that they take care of themselves with some type of self-insurance, then of course we have to do it in our old sausage-making way and we have to do it.

Ms. SUMNER. Mr. Chairman——

Chairman RANGEL. And these are revenue raisers we are talking about. The difference between—you see, when you—when you are providing incentives, it doesn't really have to be good tax law because that is just making people happy, but when you are raising revenues, it doesn't have to be good tax policy because we need the money.

So we would hope that you might think of assisting us in establishing good tax policy and at the same time raise the money because—Ms. Sumner, my sister is a nurse and she is an independent contractor and I just wonder whether or not I am going to have to pay for everything that she is not getting, you know, if she were an employee.

But she is more independent until she gets into that hospital and they don't treat her like an independent contractor. They tell her what to do, they tell her where to go, they tell her when to come in, they tell her when to leave. But when she deals with you, she is independent but when she deals with the hospital, she is a nurse and sometimes she is not. Some of the union people don't like my sister because they think that she is getting paid less money than they are and that they will keep her before they will keep the members of local 1199. She doesn't belong to 1199 because why should an independent contractor belong to a union. That is what my sister tells me. Why should she belong to a union. You know, she is independent, just one person.

But one thing, I don't argue with my sister and I am not thinking about arguing with you. I just don't understand it. But if you could share with me how your government can avoid having other people pick up other people's expenses that don't take care of themselves, maybe you might want to do with it your contractors to give them a group health insurance program. You think you might consider charging them just a little bit, saying I know you are independent and you are a contractor, but my broker firm offers group insurance for you individually?

Ms. SUMNER. There are lots of resources available to professional nurses to provide for their own health insurance, life insurance, disability insurance.

Chairman RANGEL. That is what I tell all those people who end up in the public hospitals. There are a lot of resources out there if you had only been responsible to take care of yourself. I tell that to most of the old folks without Social Security. You got old, we told you not to get old and you should have gotten some job where you would have made a contribution and forced employers but, no, you had to be smart and be independent and you are out there now and you are sick and you are old and you got nothing.

The broker firm, they don't even know, you didn't sign up your contract and the plays you worked for 20 years, they said you were an independent contractor. And so then everybody has to pay for this person.

Mrs. Clinton said that is not right, that is not fair, it is not equitable and she wants everyone to have coverage one way or the other. If not by you, the contractor, if not by the brokerage firm, if not by the general contractor, then somebody other than expending more Federal funds.

So we are going to do it our way, but if you can think of some way to meet us halfway without causing undue embarrassment to your industry, it would certainly be appreciated.

[The following was subsequently received:]

Criti Care inc.

October 4, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
1102 Longworth Building
Washington, DC 20515-6348

RE: Committee on Ways and Means, Subcommittee on Select Revenue Measures Hearing on Miscellaneous Revenue Issues - September 21, 1993

Dear Ms. Mays,

Pursuant to Chairman Rangel's invitation to do so, thank you for the opportunity to supplement some points in my testimony on September 21, 1993 before Congressman Rangel regarding the above-mentioned Subcommittee. Please append this letter to that testimony.

Nurses working as independent contractors (IC) through brokers are independent professionals. They function based on each State's Nurse Practice Act and Professional Standards of Practice. Even when working as independent contractors in an institutional setting the ICs enjoy control over the critical aspects of their work environment which clearly distinguish them from employees. They are free to accept or reject any shift, can work as often or as little as they want, do not have to attend institutional "staff meetings", and are responsible for their own continuing education and other expenses. They can select the institution(s) and/or unit in which to practice their profession and often base this component of their decision on quality of care issues.

MEMBER OF
NBCA
NURSE BROKERS &
CONTRACTORS OF AMERICA

Hospital policy and procedures are simply standards of practice and do not vary in key points from one institution to another and cannot form the basis for concluding that a nurse cannot operate as an IC. Likewise, nursing care and its practice is also similar from one institution to another. Following is an example of Standards of Practice and Hospital Policies/Procedures:

> **A hospital may advise a nurse in the method of a certain dressing change, indicating a particular piece of equipment to be used, like a kit for a sterile dressing change. The nurse understands the concept of sterile technique and can use his/her own judgement in assembling the necessary supplies when the specific equipment is not available. This action accomplishes the goal of patient care and yet does not follow the hospital's policies and procedures.**

You can see by the example, all nurses must always make independent, professional assessments regardless of attempts at control and direction by the hospital. In fact, nursing malpractice would occur if a nurse implemented an action, *ordered by the hospital*, which was detrimental to the patient. In short, one cannot distinguish an employee nurse from an IC nurse by focusing on nursing practice or hospital policy.

Congressman Rangel's statement about nursing practice is understandably similar to that commonly held by most lay people. It tends to focus on the standards of nursing practice and sees them as hospital requirements, rather than legal and professional (and JCAHO) requirements that are merely passed on by any medical facility in which any health professional practices. One would hardly doubt, for example that physicians can be ICs in a hospital setting even though they use hospital equipment and follow medical practices mandated by hospitals as the result of legal and professional (and JCAHO) requirements. Yet there is often an inability to see the nurse practitioner who is an IC in the same light, because perhaps of a historical pattern of paternalism towards nurses, who are mostly female, by the male-dominated medical/hospital industry in the past. With changes in health care delivery and improved earnings, nursing is recognized as an integral and independently professional part of the entire health care system.

Since there is a recognized nursing shortage in most areas of the country, nurses do not have to be independent contractors in order to secure work. Most nurses continue to be employees of institutions rather than independent contractors. Other nurses choose to work as employees of agencies which can assign them at will, monitor and train them, or pay some of their expenses. Such employee nurses recognize the security and benefits afforded them in this role, and so they are willing to give up many freedoms mentioned earlier -- freedoms which distinguish IC nurses from employee nurses. Yet, there remains a good number of nursing professionals who desire self-employment as an option. They should not be discriminated against just because they are nurses or just because they function in a highly-regulated work environment like a medical care facility. In fact, if they were accountants, lawyers, engineers or physicians, who are predominantly male, they would not be discriminated against anywhere near the same degree. I urge you to retain Section 530 for all workers -- including nurses -- and to, implement a bill similar to HR5011, and eventually to address the Twenty Common Law Factors used in determining worker status to more accurately reflect activity in the "real" world.

Thank you for the opportunity to provide additional comments for the record. Please do not hesitate to telephone me with any questions. I would welcome the chance to meet personally with Chairman Rangel to further explain how the IC nurse and the nurse broker operate.

Very Truly Yours,

Sally M. Sumner

Sally M. Sumner, RN, CCRN

Yes, Mr. Owen.

Mr. OWEN. Mr. Chairman, I just had a few more comments on the issue of having us withhold for our contractors. It sounds like a good idea and I think it is something that we at ABC will try to look into for you.

However, again, in our case, we don't have independent contractors for 10 years or 5 years or even 1 year. Our independent contractors are expected to move from company to company from job to job and the goal is to get them started, get them to build their businesses and then create their own benefits, do what they have to do for their employers, but second——

Chairman RANGEL. Second, we can find some criteria that——

Mr. OWEN. But here is the other problem. I think that unless this 20-point question business by the IRS is altered, which was one of the fundamental issues that we want to talk about, I think that having us withhold for these people is another foot in the door to us being termed as misclassifying these people and that they should in fact be employees. I think that issue has to be looked at.

And overall, most contractors play by the rules. Most of our people are employees. Most of us have good benefits. If we are asked to withhold for our independent contractors as they build their businesses and go on to the next job 6 months later, if we do that, there is still that segment in our industry and all industry of tax cheaters. They don't just cheat on misclassifying employees they cheat on everything. So that is the segment of the construction industry and any other industry that has really got to be dealt with.

Chairman RANGEL. Mr. Owen, you are right and I didn't mean to suggest that I was offering a solution. Really what I was trying to say is that if I were in your shoes and I saw this big train coming down the tracks and I thought that they had a real economic problem, I would try to help them to take care of that problem in a way that I could best live with.

I wish they wouldn't look at me to take care of it, but you know that there are abuses and you know there is a hemorrhage in funds with the Federal Government and if you have any idea how we can just inconvenience you but at the same time take care of this problem, it would make it a heck of a lot easier than just to wipe out the whole thing and then let you figure out, you know, how to do it, since we can't really do it by ourselves.

We—the chairman is always trying to work out the differences with any complex matter where you are dealing with subjective levels of having to make a determination. I tell you because of attitudes where people have got to tell you it looks like a duck, it walks like a duck, it quacks like a duck but it is really not a duck because I said it wasn't, that is not going to fly.

And so what you are going to have to do is sit around the table and say we are honest and they are not and this is what honest people are prepared to do even though it is a tremendous inconvenience to us, because the easiest thing to do—it would be unfair and inequitable—is just to take a cleaver and cut it, chop it off and start all over and see where the inequities are and then repair the laws.

We don't want to do that, but this dog has been around a long time and it is causing us a lot of political problems. It is causing us more political problems than the independent contractors are having. And I recognize it is causing a lot of problems for the general contractors and brokerage firms, but to the independent contractor—employee of the independent contractor, and we are the only—I assume, Ms. Sumner, that the independent contractor in your business is only the nurse. She is the business.

Ms. SUMNER. That is correct.

Chairman RANGEL. That something is going to have to be changed and I don't know how and that is why we are having these hearings, so that when the chairman and members get together they would ask, did you receive any suggestions that could relieve your government of this problem and at the same time increase revenue.

And I would tell—have to say that, you know, we have to study all the testimony, but I don't remember that those who would be adversely affected by this law making any suggestions that could do those things. But I will never say that until after, one, I read the testimony, discussed it with staff and still had the opportunity to review any additional information that you might want to submit, if the record was left open for 5 days, that would deal with how I report back to the full committee.

I say this with all compassion for the role that you play here today, an advocate, the same way I as a lawyer would have to protect my client until the judge asks whether we can talk. That is what I am saying now, that this is a very, very difficult and complex question and I would strongly suggest that you find out ways to assist us in working out something that would be less painful than this bill.

Yes, Ms. Sumner?

Ms. SUMNER. Well, one of the suggestions that we have considered for a long time in terms of the ability of the government to collect money is to alter the reporting requirements. What happens now is I comply with the law and issue 1099s to all the workers who contract with me. And to the best of my knowledge, and I do follow up on that, they all claim that money and pay their taxes.

The problem is the people who don't get 1099s may not report the income. I would suggest that there may be components of that H.R. 5011 from last year——

Chairman RANGEL. That is just one of the——

Ms. SUMNER [continuing]. That may help.

Chairman RANGEL. But nurses is a real problem as to whether they are independent contractors. What is the average length of service to one general contractor that your independents would have?

Ms. SUMNER. It is based on a shift. That is really the only length of service.

Chairman RANGEL. You sound like one of those witnesses that if they didn't ask the question, you ain't going to give the answer.

Ms. SUMNER. I am trying to give you the answer.

Chairman RANGEL. I know. What I am trying to find out is that if someone was to say to one of your independent contractors, "How long have you contracted with this hospital as opposed to how long have you worked with this hospital"——

Ms. SUMNER. I have had hospital clients that I have had for the full 12 years that I have been in business. The service that has been provided to them by the nurse has not been consistent. There has not been one nurse who worked consistently for one hospital more than a few weeks.

Chairman RANGEL. Why don't you help me frame the question? How many nurses do you have that are independent contractors that have worked for one of your clients for over a year?

Ms. SUMNER. You are trying to pigeonhole the answer to be what you want and I can't give it to you that way.

Chairman RANGEL. Why don't you give an answer to the question that I didn't ask that would be the one that you know that I want.

Ms. SUMNER. There are 250 contractors who I have on file. At any given week there may be 30 of them who work. Most of the time those people do not work for one hospital client. The nature of the business requires them to be available to work at a number of different clients, a number of different shifts on a number of different days. There is significant inconsistency in their jobs.

Chairman RANGEL. Is your brokerage firm considered small, medium, or large?

Ms. SUMNER. My firm would be small, small to medium.

Chairman RANGEL. I am not even talking about your firm, then. I am talking about larger firms that if you didn't know they were independent contractors they would be like—I started to say like crew chiefs of migrant workers, but that is almost the same thing when you get to the building industry in a sense.

Mr. DESJARDINS. Mr. Chairman, I might make a comment regarding withholding. Withholding is an option. It would increase revenue, I am sure, to the government. I come back to the same problem about what we withhold on. If it is the labor, we would have to identify that and break it out. It would cause additional inconvenience to the general contractor but, you know, I don't know if we would finally support that or not, we would have to discuss it.

But my sense is it would only be supported if the issue of the independent contractor would go away. I think we would not want to hassle with withholding while we are still arguing the issue of independent contractor status. So if withholding would replace the problems we have with the independent contractor status, that may——

Chairman RANGEL. We have to do a lot of things and that would be one, but you would have to admit that if the criteria is that the IRS did not catch a misclassification that you have a safe haven from anybody else that you must classify or that you may misclassify that that is not exactly fair to the government in a sense knowing the IRS's limited resources. It seems like if they don't get you that you are free to do what you want. I am not saying that many people take advantage of that loophole. It really means the government did not really provide the proper oversight. We have a lot of the problems and they are all not the industries.

It is the government not making it abundantly clear to you exactly what we expect and also not making as clear as you would like it as to what we consider an employee and who we would consider a general contractor. We would start off with nurses right away and say employees and work our way up.

I mean, true, we will have a lot of problems, but that is the direction which we would go until we actually got with the person that has 112 different contractors and they go from job to job and you very seldom know who the employees are, you just deal with the subcontractor.

But it is difficult for us and that is what I am saying is that we are going to have to go beyond just saying no. That is all. And I accept the eloquent and reasonable testimony in just saying no today and hope that you do find time to say, but if you have to hit this again, I wish you would take these things into consideration, and even to the point of saying you get back to us if you are organized enough to do that, as some industries are, to see whether we can work out the sticky details.

Mr. Pyles.

Mr. PYLES. Yes, I just wanted to remind the chairman that this is really a tax misclassification and a benefit and health quality issue in our part of the industry. Members of our association have expressed the opinion to me that a lot of this misclassification by new companies springing up that happened since section 530 was enacted would probably go away if you had withholding for amounts paid to independent contractors and required the distribution of an information statement that described the kinds of protections and benefits that would be foregone by this classification.

Chairman RANGEL. How do you answer Mr. Desjardins in terms of separating the labor costs from supply? How would you——

Mr. PYLES. The labor force from supply help?

Chairman RANGEL. No, no, material.

Mr. PYLES. I see, in calculating the percentage. A suggestion was made I think a year or 2 ago by GAO that there be a flat percentage of wages paid. That I would think would be a relatively easy thing to administer and then materials wouldn't be included in that. Again you wouldn't be hoping go capture everything but you would just be providing—avoiding this incentive which now exists for businesses to go out and misclassify. So I think a low percentage, for example, of wages paid would be an interesting approach.

Chairman RANGEL. Mr. Desjardins, what is the big deal about a subcontractor having receipts for what materials that he bought and——

Mr. DESJARDINS. We don't ask for receipts.

Chairman RANGEL. You don't have to.

Mr. DESJARDINS. We pay—many independent contractors get paid what we call piecework. A person installing reinforcing steel gets paid by the pound or someone installing tile gets paid by the square foot. And so we—and that is how the work is bid. We get prices from——

Chairman RANGEL. You get the prices the same way. We won't change those traditions, but you go in—and I am just using something I am familiar with—and you say what does it take to fix the car and the guy says $2,000 and then you get your bill and find out that, you know, it was $500 for materials and $1,500 for labor. I assume there would be a dramatic reduction for tax purposes in this case, but, you know, they do it and it is an estimate. We don't go in and say show us the bills for the $500 of materials you bought, because we got to pay the $2,000 anyway.

Anyway, listen, all of you have done a good job. You have been very helpful, but we need some more. Mr. Pyles generally has showed you the direction that we would be going and we don't want to go there alone. If we make mistakes, at least we want to know that we reached out. I don't think there is any committee and certainly subcommittee that any taxpayer has more access to than our committee.

It doesn't mean that we always agree, but we certainly—we always listen. It doesn't mean we always do what you would want. So we hope in this area that you might come up with some ideas that are less painful but at the same time can catch us up with health reform and the other things in the direction that we are trying—deficit reduction, raising some money without raising your general taxes.

We can put a tax on the general contractor but you wouldn't want us to do that in order to get the money that the subcontractors are not paying.

I don't know what we are going to do, but I would want to make a more positive report to the chairman, to be more honest with you, and you can help there. Probably there are some things in some trade magazines that should have come across our desks. Maybe staff has some ideas that they will suggest that we get in touch with you and get your opinions on.

We thank you very much and the committee will stand adjourned subject to the call of the Chair.

Thank you very much.

[Whereupon, at 3:12 p.m., the heariang was adjourned, to reconvene on Thursday, September, 23, 1993, at 10 a.m.]

MISCELLANEOUS REVENUE ISSUES

THURSDAY, SEPTEMBER 23, 1993

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures
Washington, D.C.

The subcommittee met, pursuant to call, at 10 a.m., in room B–318, Rayburn House Office Building, Hon. Charles B. Rangel (chairman of the subcommittee) presiding.

Chairman RANGEL. Good morning. We are starting today a continuation of the Select Revenue Measures on miscellaneous issues that have been assigned to us by the chairman of the full committee.

Today we will take testimony relating to generation skipping tax and rollovers of military separation pay into individual retirement accounts. We also will take testimony on various revenue raising proposals. They relate to among other matters, real estate, ozone depleting chemicals and environmental remediation expenditures.

This is our 7th day in covering a variety of subjects that have been referred to the committee, and I want to thank the witnesses, the Members that have participated in these long hearings, and the staff and subcommittee for their work on these hearings and all of the people that have taken the time out to share their views with the subcommittee.

Because this is the last day that we have and because we have several panels, I will ask the witnesses to try to keep their remarks to the 5-minute limit, with the understanding that the full statement, without objection, will appear in the record.

At this time, I would like to yield to my friend for the purposes of introducing one of the witnesses.

Mr. SANTORUM. That is the next panel.

Chairman RANGEL. I am terribly sorry. OK, then we have a member of this committee, a standing Member of Congress, as well as Ways and Means, Jim Bunning from Kentucky.

STATEMENT OF HON. JIM BUNNING, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF KENTUCKY

Mr. BUNNING. Thank you, Mr. Chairman, and Mr. Santorum, good to see you, too. I want to thank you for the opportunity to testify before this subcommittee today in support of a Tax Code provision that will benefit military retirees for years to come.

The provision is similar to legislation I introduced earlier this year, the Military Separation Retirement Benefit Act. This provision would allow military personnel to rollover their separation pay into an IRA.

Because of the military downsizing, the Department of Defense has been offering special separation pay benefits to encourage active service personnel to voluntarily separate from the military service. The benefit is based on military rank at the time of separation, as well as years of service.

This benefit is intended to compensate our military men and women who are being forced to surrender the security of their chosen jobs and end their chosen careers in military service prematurely. However, as soon as service men and women accept the separation pay, they discover that it is taxed as regular income. In addition to the cash incentive, they also are handed a big tax bill.

My provision would give these military personnel some flexibility at the time when they are faced with difficult career choices and uncertainty. My provision would allow them to rollover their separation pay into an individual retirement account within 60 days of receiving it.

I think it is just a matter of simple fairness. Many of the folks who are affected by this tax provision have already served their country for at least 10 years or more. They have been working toward a pension which is fully recognized by the IRS. Military earnings statements note that military personnel are covered by a pension plan and, as a result, they are subject to various tax regulations, such as being prohibited from fully deducting annual IRA contributions.

Most of these service men and women intended to serve in the Armed Forces for life or at least 20 years. It is their chosen career. And they counted on the security of military retirement that they were working toward. But now, due to the changing world and conditions and economic constraints beyond their control, that promise of future personal security is gone.

I think that these men and women, who have served our country bravely, deserve better than a big, fat tax bill as they wind up their military careers. The least we can do is give them the opportunity to hold on to one small piece of that security by using their separation pay to invest for their future retirement.

Rolling over separation benefits is not a new idea. Many private sector employees are provided with this option through separation benefit packages provided by their employers, when they are faced with a similar situation.

Federal employees are allowed to take the retirement funds that they have accumulated through contributions to the Thrift Savings Plan and roll them into an IRA. They can continue to save for their retirement without penalty. They are given that option. I think it is only right that we give the same option to the members of the Armed Services. Right now, all we give them is a lump sum and a big tax bill.

It is no secret that the number of military personnel who will be affected by this inequity in the Tax Code is growing. Last year, as many as 55,000 military personnel took early separation from the military under the current incentives. This year, pending approval by Congress, approximately, 114 military bases and installations will be closed or reduced in size.

The 1994 Defense Authorization Act, currently being debated, cuts the Defense Department's budget by $11.5 billion in 1994. It also sets a target reduction of Armed Service personnel at well over 100,000 in 1994.

With these facts in mind, it is clear that we need to make this retirement benefit option available as soon as possible. It is the only way to insure that those affected by the military cutbacks can leave their service careers with some sort of retirement security for their future.

I am pleased that my bill is supported by the chairman of the Veterans' Affairs Committee, Representative Sonny Montgomery, and the ranking member, Representative Bob Stump. It also has received support from members of the Armed Services and the Ways and Means Committee.

A provision similar to the Military Separation Retirement Benefit was included in H.R. 11 last year, by Senator Murkowski. It received wide support during committee considerations and in conference. I think it deserves the same support now.

I want to thank you, Chairman Rangel, for the opportunity to testify and for your consideration of this important provision.

Chairman RANGEL. Congressman Barlow, would you mind if I just asked a couple of questions since you are here on a different subject?

Mr. BARLOW. Please.

Chairman RANGEL. I think what you are saying makes a lot of sense, and it is my understanding that you are not dealing with retirement pay for military people.

Mr. BUNNING. No, we are dealing with those who are RIF'd. "Reduction in force."

Chairman RANGEL. So this is before they really have a vested retirement income——

Mr. BUNNING. That is correct.

Chairman RANGEL [continuing]. And this is to protect them, to have at least something to depend on in the longer term so that they can better plan for whatever life they are going to have in the private sector?

Mr. BUNNING. I believe that is correct, and I sincerely believe that after someone spends 10, 12, 14 years in the military, and then is asked to leave by the military, and with this incentive given at that time, there ought to be an option at that time. And that is what this is all about.

Chairman RANGEL. Do you have any idea—I mean there is no question about its equity and fairness; do you have any idea about the cost?

Mr. BUNNING. Yes, sir, I do.

Chairman RANGEL. What is it?

Mr. BUNNING. It is $190 million over 5 years, and that is as of this morning. Hank Gutman of the Joint Tax Committee has given me that number.

Chairman RANGEL. Now, there was a similar provision that came through the Senate last year in H.R. 11, and they——

Mr. BUNNING. They said it was $167 million at that time, over 5 years.

Chairman RANGEL. But they had a cap. Are you willing to accept—they had a $25,000 cap for the rollover.

Mr. BUNNING. That would be a big plus, comparatively speaking, if you had a cap. But I would prefer that there not be one. We will find a way to pay for it if we get the opportunity.

Chairman RANGEL. Who are "we," Congressman?

Mr. BUNNING. Those of us who are proposing it.

Chairman RANGEL. OK. Well, you know that is important, and, of course, if it could come from the same budget, it makes it a lot easier for us.

Mr. BUNNING. Well, it was paid for in H.R. 11 by a provision that would prohibit deductions by corporations on legal fees incurred in corporate buyouts and takeovers.

Chairman RANGEL. Well, we have to get votes for both, and while yours may not be controversial, the funding mechanism might be. But I would be anxious to work with you on this.

Mr. BUNNING. Thank you very much.

Chairman RANGEL. Mr. Santorum, do you have any questions for him?

Mr. SANTORUM. No, thank you.

Chairman RANGEL. Thank you so much. We will work on this together.

STATEMENT OF HON. THOMAS J. BARLOW III, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF KENTUCKY

Chairman RANGEL. Mr. Barlow, from Kentucky, and we are anxious to get your testimony, too.

Mr. BARLOW. Thank you, very much, Mr. Chairman. I appreciate your time and your interest in this matter. It is a very important situation for some of my constituents in western Kentucky and, indeed, across the Nation.

We are dealing here really with one of the great success stories of science in the last 20 years and industry and science working together. Science investigation early in the 1970s, came upon the fact that CFCs, chlorofluorocarbons were eating up the ozone as the chemical was released into the atmosphere and traveled up into the higher regions. And industry, of course, as it should, questioned science. But as science convinced industry that this was going on, industry very responsibly moved in an international way through the Montreal Protocol, to get on top of the situation and get CFCs out of the industrial processes and commercial processes.

One of the ways it was done, was to put a punitive tax on CFCs, and then technology has been pushing hard in this area from science and from industry to move us into other generations of chemicals which will give us the qualities we need. For example, in insulation, and air conditioning. And we are into second-generation chemicals now, which are called HCFCs. Rather than get into the full chemical nomenclature, HCFCs are 90 percent better than CFCs, in terms of reducing the eating of the ozone that goes on by the old CFCs.

And yet, what is being proposed here is that that same punitive tax be placed on HCFCs virtually that was placed on the original CFCs. We have a situation here, quite frankly, Mr. Chairman, of science and industry working together in a very responsible way, to move us out of a situation which was, frankly, going to put the world in peril, moving very quickly to the next generation chemical products that would give us the same attributes as the old chemicals and yet getting rapped just as hard in a punitive tax way, for their success, for their cooperation.

We are not talking about a lot of money here. I understand that we are really only talking about $10-, $15 million in tax revenue. What we are talking about, I think, is just a continuation, a kind of a knee-jerk reaction. We had a tax approach with the old chemicals, which were troublesome, very dangerous, lethal, in fact, in terms of environmental characteristics over time, but now we are moving on to the next generation of chemicals.

We will go on to a third generation of chemicals within short order, just as soon as technology is developed, which will take us out of that last 10 percent of cleanup that we need. But I don't think that we need and want this tax if we are going to encourage industry in the future in other areas, to work together with science as we come up with other problems in other chemical structures and other market structures.

We want to encourage them to move out of problem areas, move into the better areas with the chemical technology, a better chemical technology fix, and to do that, we need to be encouraging people, not rapping them on the knuckles.

This is a very unwise tax, I think, to apply to this next improved generation of chemicals, and I would urge the committee to strongly oppose it.

[The prepared statement follows:]

U.S. REPRESENTATIVE TOM BARLOW'S TESTIMONY BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES

September 23, 1993

Mr. Chairman, members of this subcommittee, I first want to salute Chairman Rangel for his excellent leadership chairing this subcommittee during the budget reconciliation battle. As a freshman member, I especially appreciate the consideration that the Chairman and this subcommittee have shown me during this busy year.

I am testifying today to express my concerns and the concerns of many of my constituents regarding a proposal to levy a tax on HCFC's (hydrochlorofluorocarbons"). This proposal would: (1) be a punitive measure inflicted upon industries that are attempting to be environmentally responsible; (2) severely harm an industry important to my Western Kentucky district; (3) harm the environment by discouraging movement away from CFC's that have 20 times the ozone depleting potential of HCFC's; and (4) probably will not raise the anticipated revenues.

The Montreal Protocol requires signatory nations to eliminate the use of ozone depleting chlorofluorocarbons by the year 1996 and HCFC's by early in the next century. The Protocol mandates the elimination of ozone depleting CFC and HCFC compounds in three phases in recognition of technological problems associated with developing new non-ozone depleting compounds. It also provides industry with a rational schedule for transitioning between 1st generation CFC's to 2nd generation HCFC's and finally 3rd generation non-ozone depleting compounds.

In the first phase CFC's ("chlorofluorocarbons"), that caused maximum ozone depletion, will be eliminated by January 1, 1996. Industry is currently using the second phase replacement known as HCFC's. HCFC's are a major environmental improvement over CFC's because HCFC's have only 1/20th of the ozone depletion potential that existed with CFC's. Industries that once used CFC's have in recent years, invested millions of dollars to convert from CFC's to HCFC's. Some industries that rely on HCFC's have no alternative chemical to use until third generation chemicals known as HFC's ("hydrofluorocarbons"), are commercially available.

I understand that many have criticized the industries for not moving quickly enough to develop the new generation of compounds. Replacement does not occur in a short time frame. This process takes years of testing by the user industry groups and the EPA regarding such as toxicity and flammability before approval can be given by the EPA for replacement in affected industries. Subsequent to that approval companies must make retrofit and conversion modifications, which in itself can take years.

If this committee decides to tax HCFC's in a manner similar to the tax that is presently applied to first generation CFC's, such a policy could defeat the goals of the Montreal Protocol by discouraging on-going transition away from CFC's. The Montreal Protocol wisely coupled the obligation to convert to more environmentally sound compounds with a benefit of allowing affected industries time between conversion dates to bear the economic burdens imposed by the conversion requirement. Already, industries have invested millions of dollars to convert their equipment and manufacturing processes to HCFC's rather than CFC's.

Market and competitive forces are already driving industries to utilize third generation compounds as soon as they are technologically and economically feasible. A tax will not speed conversion to third generation compounds now under development. The phase out dates for second generation HCFC's are already established by the Montreal Protocol and by EPA action under the Clean Air Act.

Additionally, taxing HCFC's would adversely impact an industry that is very important to my district. One of the primary suppliers of HCFC's across the nation has a plant in Calvert City, Kentucky that employs almost 300 constituents. Further, the company is investing over $150 million dollars in its Calvert City facility to press ahead with the development of third generation HFC's.

One industry segment utilizing HCFC's will illustrate why a tax on HCFC's is a bad public policy and bad environmental policy. That market is the rigid foam insulation market. You may have seen this product before, but in case you have not, rigid foam is a revolutionary insulation product that combines high insulating factors with certain performance characteristics that are not achievable with other products. Builders use rigid foam insulation because it fits within the wall of a building without taking up much space.

The manufacturers of the high grade insulation find that approximately 30 percent of their raw material manufacturing costs involve HCFC's. I understand a pound of HCFC's costs approximately $1.32 per pound. Imposing a tax of $1.00 to over $4.00 a pound on HCFC's would make the cost of producing high grade insulation prohibitive, Give the price sensitive nature of the building materials market, the energy savings benefit of this material would be lost to less efficient materials. Therefore, while the intent in taxing HCFC's may be motivated by environmental concerns, the proposal will instead harm the environment while destroying an industry in the process.

In conclusion, the proposal to tax HCFC's will not speed conversion to third generation compounds but instead will harm an industry important to my constituents as well as harm rather than help the environment, and produce little additional revenue. Accordingly, I ask that this distinguished subcommittee reject this proposal and thank you for the opportunity to share my concerns with you.

Chairman RANGEL. What is happening to prepare the industry and the plant in your district; to prepare the workers for the change when it does come?

Mr. BARLOW. We are finding our chemical plant there making aggressive investments in the production of the new product, this second generation product.

I believe they have scheduled investments of over $150 million at this point. They also are pressing hard on the technology and the chemical breakthroughs for the final generation, the third generation, which will get us completely out of ozone-eating chemicals in the environment. They are pressing ahead very aggressively on that.

The first companies, as you can understand, that achieve the technological breakthroughs in this, will have a market edge, will have people waiting for their product. So it is not a matter of having to push people ahead here. People in the industry are moving as fast they can. They know there is a problem; they want total cleanup, and the market forces are out there waiting for that last generation, that final generation chemical to come along. So we don't need to be beating on them with the same force that might have been wise in the first rounds.

Chairman RANGEL. Do you have any idea whether there is similar impact on employees with the other plants? How many workers would be affected nationally the same way the plant affects your constituents?

Mr. BARLOW. I don't have the figures on that, but I am sure there are other plants, not just in the United States, but around the world, that will be impacted on this and we will get those figures to you.

Chairman RANGEL. Well, the world impact, I don't think is going to have as much impression on the Congress as constituent impact. And it could very well be with the panels we are going to hear from, we will see what progress is being made and whether the tax is causing more problems than progress. Politically speaking, I guess some Members thought, not only would we raise some money, but we would encourage a substitute more quickly, but that is a scientific question I am certain the experts will be able to help us out with.

But the committee has to consider the impact that this is going to have on industries that hire many people during this time of unemployment and transition, so your testimony is going to be taken into account and I assume the industry could help out to see how many other members would have the same problems and whether, in addition to your concern, that we should be talking about conversion and what can we do to help train the workers so that you would not have the full burden of the emotional and political problems that changes cause. Maybe we can think as painfully we had to think in military conversion, as to what obligation would the Government have to assist people with new skills.

Mr. BARLOW. I appreciate that and we will get that information to you.

[The information was not obtained at the time of printing:]

Mr. BARLOW. I would say that we want to be encouraging the investment in this country of the plants with the jobs that go along with them for the second- and third-generation chemicals, and if we come along at this stage of the game with punitive taxes on the second-generation chemicals, we are sending a clear signal to the chemical industry to locate elsewhere, outside the country, where they might not run into the punitive tax—locate in South America or Europe, these new chemical plants. And I think that would move us out of the position of leadership that we want from a policy standpoint, in addition to the jobs that we would lose.

Chairman RANGEL. Well, I would, of course, there has to be evidence that really we could lose the business because they are not competitive with foreign manufacturers, but I would assume that one of the reasons, besides being punitive, would be to encourage people to think seriously about alternatives, if, indeed, the market price was more level than with the cheaper HCFCs.

But, in any event, the tax serves a lot of purposes besides revenue. And I think your testimony is the tax could be causing more harm than good and we should review it, and we certainly will.

Mr. BARLOW. Thank you, sir.

Chairman RANGEL. Thank you.

Chairman RANGEL. Any questions, Mr. Santorum.

Mr. SANTORUM. No, thank you.

Chairman RANGEL. The Chair yields to my colleague on the committee for the purposes of introducing a witness on panel one.

Mr. SANTORUM. Great. Thank you.

The gentleman I would like to introduce is Mr. Roy Hock. Roy is the chairman, president and CEO of Technitrol, which is a Philadelphia-based company, but it happens to have two plants in my district in McKeesport. They employ over 1,100 people all over the world in 10 States in the United States, and the United Kingdom and Puerto Rico. So he is here to testify before the committee.

He is an active member of the Philadelphia Chamber of Commerce, where I got to know him, and is also active in low-income housing in the Philadelphia area, an important problem facing Philadelphia and many other urban areas. He is here to testify concerning the deductibility of remediation cost. And it is my pleasure to introduce him to the committee, Mr. Chairman.

Chairman RANGEL. Thank you, so much.

Other members of the panels are Wayne Robinson, director of taxes of GenCorp, representing the Coalition for the Fair Treatment of Environmental Cleanup Costs; Fred Gentile, senior vice president of The Brooklyn Union Gas Co., Coalition to Eliminate Tax Barriers to Environmental Cleanup Costs. The Brooklyn Union not only employs a lot of good people in the city of New York in the county of Kings, but is involved with a lot of community matters that, even though I seldom get a chance to visit that wonderful borough, it helps our great city a lot and we appreciate it. And Michael Solomon, partner in Ivins, Phillips and Barker.

We will start now with Mr. Hock.

STATEMENT OF ROY E. HOCK, PRESIDENT, TECHNITROL, INC., TREVOSE, PA., ON BEHALF OF COALITION TO PRESERVE THE CURRENT DEDUCTIBILITY OF ENVIRONMENTAL REMEDIATION COSTS

Mr. HOCK. Thank you, Mr. Chairman, for the opportunity to appear today and present views on a proposal to clarify the treatment of environmental remediation costs. I appear on behalf of a Coalition of Companies, and my brief comments will be covered in greater detail in the written statement which has been provided to the committee.

The position of our coalition is that environmental remediation costs should be deductible. I give the following reasons: First, the current law allows current deductibility of expenditures incurred in repairing and maintaining property and equipment if there is no increase in value, life or function. Existing standards measure an increase by comparing the attributes I have just listed prior to the condition that necessitated the expenditure with the condition after the expenditure.

The occurrence or discovery of a condition requiring environmental remediation decreases the value of the asset or property when it becomes known, and remediation, at best, restores the value to the original level with no increase in life or function.

My company, Technitrol, I give as an example where we in the recent past removed two oil storage tanks. Both tanks had leaked, both tanks had contaminated the soil around the tanks and remediation was accomplished.

In the first case, the tank had been abandoned. It had not been in use and was not being restored. The ground then was returned to its original condition and no increase in value was obtained.

In the second case, the tank was replaced, in compliance with the underground storage tank statute, in which we now have to have a given date, and we are trying to get ahead of that date, put in tanks that meet the crude requirements and also have the ability to detect leakage if it occurs in the future.

In both instances, remediation was expensed, as it did not provide any increase in value, life or function. In the second case, the tank and the related leak detection equipment was capitalized, as they provided this increase.

The second reason I give is that matching the future income with related expenses is one reason for capitalizing an expenditure. Environmental remediation costs, as a general matter, relate to prior activities of the taxpayer or previous owner and do not provide an ongoing benefit beyond that associated with the general welfare.

As of today, current costs of complying with the present environmental laws are an allowable deduction. My company, Technitrol, for instance, has 12 plants. Nine of these plants have processed wastewater treatment facilities. The cost of running these and also in complying with other environmental laws, runs over $600,000 per year. Our total sales are about $100 million. This sum consists of labor, material, employee training and are directly chargeable to outside services to operate our facilities within the law. All these costs are deductible.

In addition, we average over $100,000 per year of capital expenditures to meet new requirements or to allow the use of new chemicals that replace those being eliminated. That is in keeping with the testimony we just heard relative to CFCs. Therefore, it seems only logical and consistent that the remediation cost for correcting the effects of prior practice or events, which are now recognized as an environmental problem, would also be an allowed deduction in the year that those costs are incurred.

All of us in industry would like to have known years ago what we know today about how to prevent such occurrences. The cost then that would have prevented this would then have been expensed and would have been matched with the revenue occurring at that time.

Third, in an era when preservation of our natural resources has attained the highest degree of prominence, public policy would justify a tax policy that encourages environmental remediation activities. In contrast, a proposal that would single out these activities for less favorable treatment by capitalization by mandating that, must be judged as a seriously flawed proposal.

The members of our coalition, and we, believe industry in general would like to get remediation of old environmental problems behind us, and we truly would like to do that. Some of them have hung around a long, long time and we would like to get on with it. Our ability to do this quickly, because of the magnitude of the problem, is probably limited by our ability to sustain the cost. And I think that is over all of industry that we have to speak that way, not particularly my firm.

Any unfavorable tax treatment of remediation expenditures could further impair the timely cleanup activities. My company, Technitrol, has a finite amount of new capital to invest each year. We do earn money, we want to invest it back in the business. Our corporate goal is to expand our business and create new products, new jobs, and thereby create value for our shareholders, who are the public. We are a public company. An unfavorable treatment of remediation expenditures might someday put us in the undesirable position of not having the wherewithal to do both and having to choose which we are going to do.

In closing, I would like to urge Congress to confirm that environmental remediation costs are deductible and I think thereby eliminate the concern that was expressed by Mr. Samuels just the other day, and industry, of having the IRS and the taxpayers entering into costly litigation.

I would be happy to answer any questions at the appropriate time.

Thank you, Mr. Chairman.

Chairman RANGEL. Thank you, Mr. Hock.

[The prepared statement follows:]

STATEMENT OF ROY E. HOCK

on behalf of

THE COALITION TO PRESERVE THE CURRENT DEDUCTIBILITY OF ENVIRONMENTAL REMEDIATION COSTS

REGARDING PROPOSALS TO CLARIFY THE TREATMENT OF ENVIRONMENTAL REMEDIATION COSTS

before the

SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

September 23, 1993

Introduction

Thank you, Mr. Chairman, for the opportunity to appear today and present views on a proposal to clarify the treatment of environmental remediation costs. I appear on behalf of the Coalition to Preserve the Current Deductibility of Environmental Remediation Costs.[1]

The tax accounting treatment of environmental remediation costs is an issue that concerns all members of the coalition and a significant number of other U.S. businesses. In general, these liabilities include the removal and disposal of solid waste and other contaminants that pose a threat to human health and the natural environment. U.S. businesses have incurred and are expected to incur in the future vast amounts to remediate the environment.

A proposal to enact legislation that would specify certain environmental remediation costs as capital expenditures, or require all environmental remediation costs to be amortized over a uniform period, is patently unsound from multiple perspectives and should be rejected. The current tax law has long provided rules that allow a current deduction for costs incurred in repairing and maintaining property used in a trade or business. The criteria for distinguishing these currently deductible costs from capital expenditures have been established through long-standing regulations and case law and have always applied uniformly to all activities.

Under the current law, a substantial body of existing case law supports the current deductibility of many types of environmental remediation costs. Under these cases, an expenditure that merely restores property to its value prior to a condition of deterioration is not required to be capitalized as an improvement. Under the relevant case law, the proper test is whether the expenditure materially enhances the value, use, life expectancy, strength or capacity as compared with the status of the asset prior to the existence of the condition necessitating the expenditure. The legal test for determining the deductibility of environmental cleanup costs should be the same test that applies to all other business expenses.

The capitalization test set forth in the case law is consistent with the fundamental purpose of any capitalization requirement, which is the matching of income with related expenses.

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[1] The Coalition members include: CENEX, Crysen Corporation, Farmland Industries, Inc., Grede Foundries, Inc., Kalama Chemical, Inc., Quebecor Printing (USA) Holdings, Inc., and Technitrol, Inc.

Environmental remediation costs as a general matter relate only to prior activities of the taxpayer or a previous property holder and do not provide an ongoing benefit beyond that associated with the general welfare of the environment.

Ideally, from a tax policy perspective, a proper matching of environmental remediation expenses with the income to which they relate could be achieved through a mechanism that would allow a deduction prior to the time the remediation work is performed.[2] Given the current revenue constraints, environmental remediation costs should be deductible, at the very latest, in the year incurred. A requirement to capitalize and amortize these expenses beyond the year incurred would distort income.

In an era when preservation of our natural resources has attained the highest degree of prominence, public policy would justify a tax policy that encourages environmental remediation activities. In contrast, a proposal that would single out environmental remediation for less favorable tax treatment than that afforded other types of business activity by mandating the capitalization and amortization of certain costs must ultimately be judged as a seriously flawed proposal.

Background

Estimates of the total environmental remediation costs that are expected to be incurred by business over the next few decades have reached staggering levels. For example, the Associated Press reported that the potential cleanup liability at existing hazardous waste sites had reached the "trillion dollar" range in 1991.[3]

Environmental remediation is unique as an issue of almost universal concern. Far from being an isolated problem affecting businesses in a few distinct industries, it has and will continue to have a major impact on the functioning and financial status of a broad spectrum of businesses. Beyond the more evident examples, such as the petroleum, chemical, mining, manufacturing, and agricultural industries, environmental remediation concerns are also prevalent in such industries as real estate development, construction, retailing and financial services.

In the less obviously affected industries, the problem of dealing with environmental remediation is not readily associated with the core activities of the business and, therefore, can be relatively more disruptive. For example, a financial institution whose primary expertise is providing financial services could easily suffer a competitive set back when forced to deal unexpectedly with a severe and unexpected problem of environmental waste on foreclosed property.

In the petroleum industry, the problem of environmental remediation permeates to small businesses, where the economic impact is potentially more severe. For example, the Petroleum Marketers Association reported that its membership of more than 11,000 independent marketers could face significant financial strain in the cleanup of soil and groundwater contaminated from petroleum leakage.[4] Apart from the significant new investment these businesses must make to replace storage equipment and develop pollution control equipment, the EPA has estimated each could face a cleanup liability ranging from $50,000 to $100,000.

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[2] For example, section 468 of the Internal Revenue Code permits a deduction for certain land reclamation and closing costs in the year the property is disturbed or produced in order to achieve a proper matching.

[3] Associated Press Release, December 9, 1991.

The need for environmental remediation results from legitimate business activities that are vital to the economy. Environmental problems such as chemical contamination of soil, and the dangers of asbestos insulation, have come about neither as a result of criminal nor negligent conduct. In most cases, the harmful effects of certain materials and chemicals were simply not known before the time the materials created hazardous conditions. Similarly, the instability of other materials in the environment could become known only with actual experience.

Contrary to what certain environmental advocacy groups may claim, a mandatory capitalization requirement for environmental remediation would undermine, not serve, the goals of these groups. The common goal of these environmental advocacy groups and the public at large is a safer, healthier environment. This goal coincides best with a tax policy that encourages timely and voluntary environmental remediation. A capitalization requirement would impose additional economic barriers to cleanup activities that are financially burdensome even when they are currently deductible.

Current Law Supports the Deductibility of Environmental Remediation

A taxpayer may currently deduct the cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, are either capitalized and depreciated in accordance with section 167 or charged against the depreciation reserve. Reg. § 1.162-4.

Section 263(a) provides that no deduction shall be allowed for (1) any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate, or (2) any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

The Income Tax Regulations provide additional guidance for applying this test. In general, the term "permanent improvements or betterments" is defined to include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Reg. § 1.263(a)-1(b).

In determining whether an expenditure results in a currently deductible repair or a capital improvement, the courts have closely adhered to the 3-factor test set forth in Reg. §1.263(a)-1(b). Thus, an expenditure is held to be a capital improvement only when the court finds that the expenditure either:

> (1) increases the value of the property, (2) appreciably prolongs its useful life, (3) adapts the property to a new and different use, or results in a combination of any 3 of these criteria.

In the case of most environmental remediation expenditures, the latter two tests can be dispensed with, as these expenditures neither lengthen the useful life of any property nor adapt any property to a new and different use. In determining that an expenditure results in a material increase in value, the courts in a majority of cases have required that the expenditure enhance the functional characteristics of the property in some fashion.

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[4] Letter dated Dec. 2, 1992, from John J. Huber, Counsel, Petroleum Marketers Association of America, to Hon. Fred T. Goldberg, Jr., Assistant Secretary (Tax Policy), Department of the Treasury.

This "increased-value" test is illustrated in numerous cases. One of the earliest cases to apply the test is Illinois Merchants Trust Co. v. Commissioner, 4 B.T.A. 103 (1926), in which the wooden foundation piles of a warehouse on a river's edge developed dry rot when the water level unexpectedly receded. To prevent the warehouse from collapsing, the taxpayer cut the rotten ends of the pilings off below the new water line, and then replaced the severed sections with concrete pilings. The Service argued that the expenditures were capital in nature because they were "repairs in the nature of replacements." In allowing the taxpayer's current deduction, the Board of Tax Appeals concluded:

> In determining whether an expenditure is a capital one or is chargeable against operating income, it is necessary to bear in mind the purpose for which the expenditure was made. To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong its life.

The Board ultimately concluded that the expenditures at issue "did not add to the value or prolong the expected life of the property over what they were before the event which made the repairs necessary." The Board further distinguished the expenditures from those properly chargeable to capital account which would include expenses incurred "in the original construction of the work or in the subsequent enlargement and improvement thereof." (citing Union Pacific R.R. Co. v. United States, 99 U.S. 402 (1879)).

In American Bemberg Corp. v. Commissioner, 10 T.C. 361 (1948), aff'd, 177 F.2d 200 (6th Cir. 1949), the taxpayer's rayon manufacturing plant became prone to cave-ins due to its situation on a geological fault. To rectify the problem, the taxpayer incurred over $900,000 to fill the underground cavities with grout and cement. The Service argued that the taxpayer's expenditure was incurred for permanent improvements or to restore property for which an allowance had been made.

In allowing the taxpayer's current deduction the court considered three factors: (1) the purpose of the work, (2) the physical nature of the work, and (3) the effect of the work. The court noted that the expenditures were intended to avert a plant-wide disaster, and to avoid forced abandonment of the plant. The court concluded that the taxpayer's purpose was not to improve, better, extend, or increase the value of the original plant. Although its continued operation was endangered, the purpose of the expenditures was to enable the taxpayer to continue operating the plant not on any new or better scale, but on the same scale and as efficiently as it had operated before. The purpose was not to rebuild or replace the plant in whole or in part. The court next concluded that the physical nature of the work was not a work of construction, or the creating of anything new. Although the effect of the work clearly benefitted the taxpayer by forestalling imminent disaster, the court concluded that this factor did not render the expenditure a capital improvement.

In Midland Empire Packing Co. v. Commissioner, 13 T.C. 635 (1950), the taxpayer incurred expenditures to line the walls and floors of its basement with concrete. The purpose of the expenditure was to prevent seepage of oil spilled by a nearby refinery that was threatening the continuation of the taxpayer's meat packing operations. Finding that the repairs did not make the building more desirable for the purpose for which it has been used, but merely served to keep the property in an operating condition over it probable useful life for the purpose in which it was used, the court allowed the taxpayer's current deductions.

In Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962), nonacq., 1964-2 C.B. 8, the court approached the increased-value test in much the same way as the Board of Tax Appeals did years earlier in Illinois Merchants Trust. In this case, the taxpayer had replaced the eroded tar lining in its water pipes with a new cement lining. This process restored the pipe's original water-carrying capacity, which had been reduced by a process known as tuberculation (erosion from the carrying of acidic water). In upholding the current deductibility of the taxpayer's expenditures the court found that the repair did not form a part of an overall plan of improvement, the cleaning and lining did not materially increase the useful life, value, or structural strength of the pipes involved, nor did it render those pipes suitable for any new or additional use. In rendering its decision, the court stated:

> Respondent contends that the value of the pipe to petitioner was materially increased by the expenditure and that it is, therefore, a capital expenditure. But any properly performed repair adds value as compared with the situation existing immediately prior to the repair. The proper test is whether the expenditure materially enhances the value, use, life expectancy, strength or capacity as compared with the status of the asset prior to the condition necessitating the expenditure.

Later cases have consistently focused on the need to measure "added value" with respect to the original operating condition of the property. In Oberman Manufacturing Co. v. Commissioner, 47 T.C. 471 (1967), the court held that the taxpayer's expenditures to correct the leakage in a factory roof were ordinary and necessary repairs. The court emphasized that, in applying the increased-value test, it is important to note that any properly performed repair adds value as compared with the situation existing immediately prior to the repair. The proper test, however, is whether the expenditure materially enhanced the value, use, life, strength, or capacity as compared with the status of the asset prior to the condition necessitating the expenditure. In applying this test to the facts, the court stated:

> The testimony establishes that the petitioner's only purpose in having the work done to the roof was to prevent the leakage and thus keep the leased property in an operating condition over its probable useful life for the uses for which it was acquired, and not to prolong the life of such property, increase its value, or make it adaptable to a different use. There was no replacement or substitution of the roof. It is true that the work included some structural change, namely, the insertion of an expansion joint in the roof. However, the evidence establishes that was the most economical way to repair the leaks and thus keep the leased property in an ordinarily efficient operating condition.

Similarly, in Niagara Mohawk Power Corp. v. United States, 558 F.2d 379 (Ct. Cl. 1977), the court concluded that the cost of repairing leaking pipes did "not increase the value of the cast iron pipelines in comparison with their original leak-free condition." The court also found that the repairs were not part of a systematic improvement plan.

As the cases discussed above illustrate, a remedial expenditure does not "materially increase the value of property" if there is no improvement in the functioning of the property or its usefulness over and above the purpose for which it was originally acquired. Environmental remediation expenses, such as asbestos removal in a building, or the removal of chemical-contaminated soil on land adjacent to the taxpayer's business as a general matter do not improve the functioning or usefulness of any assets used in the business. Although the removal and disposal of environmental contaminants benefits the environment and the general public, the expenditures do not materially add to the property's value under the test applied in this long line of settled case law.

Apart from the increased-value test, a capital expenditure may result from an expenditure that physically enlarges an asset. It is incorrect to assume that the application of the increased-value test, as described in these cases, would always lead to the conclusion that an expenditure is currently deductible. This is not the case because many expenditures do not merely maintain the status quo but enhance the functioning of the property, physically enlarge the property, or prolong the useful life of the property.

The requirement to compare the value of the property before and after the condition necessitating the repair is an easily-applied litmus test for identifying those expenditures that do not functionally enhance or physically enlarge the property beyond it preexisting state and, therefore, are not appropriately viewed as currently deductible repairs.

A significant number of cases have held that an otherwise deductible ordinary repair cost must be capitalized if it is incurred in the context of an overall plan of rehabilitation or refurbishing of property used in a trade or business. For example, while the cost of repainting an existing building, if performed separately, would correctly be treated as a currently deductible repair cost, the cost of painting performed as part of the original construction or in conjunction with a major overhaul of the building is required to be capitalized. See Moss v. Commissioner, 831 F.2d 833 (9th Cir. 1987); United States v. Wehrli, 400 F.2d 686 (10th Cir. 1968); Wilbur's Estate v. Commissioner, 43 T.C. 322 (1964), acq., 1965-2 C.B. 7); Jones v. Commissioner, 24 T.C. 563 (1955), aff'd, 242 F.2d 616 (5th Cir. 1957). The plan of rehabilitation doctrine is based on the theory that the capitalization provisions of the Code do not envision the fragmentation of an overall-project but require an inquiry into the scope and effect of a project as whole.

The general plan of rehabilitation doctrine would generally not apply to environmental remediation activities. While a taxpayer that undertakes an environmental remediation program generally must incur several distinct categories of expenses, which may arise from such activities as the removal and disposal of contaminants, monitoring, assessment, and attorneys fees, the program as a whole merely restores the property to its pre-damaged condition and therefore does not involve a plan of rehabilitation.

Under the regulations, capital expenditures are distinguished from "incidental" repairs that are currently deductible. Courts have held that the amount of dollars involved in an expenditure, either in relative or absolute terms, is not dispositive of whether an expenditure results in a permanent improvement under section 263(a) or an incidental repair under Reg. § 1.162-4.

In American Bemberg, for example, the taxpayer made a one-time expenditure of over $900,000 in 1941 and 1942 to fill underground cavities with grout. The court reached its conclusion that the expense was a currently deductible repair, however, by analyzing the nature, purpose, and effect of the work on the taxpayer's property. In R.R. Hensler, Inc. v. Commissioner, 73 T.C. 168 (1979), the court upheld the current deductibility of a large expenditure to repair equipment and machinery, stating that the size of the amounts involved should not be controlling.

In Buckland v. United States, 66 F. Supp. 681 (D.C. Conn. 1946), the taxpayer's restoration of damaged property was held to be a currently deductible repair because there was no substitution of a major unit or structural part such that "the building as a whole may be considered to have gained appreciably in expectancy of useful life," despite the fact that the total expenditure was so large that it amounted to 35 percent of the value of the building. Thus, the term "incidental," as used in the regulations, refers to the nature of the work being performed in relation to the taxpayer's specific property being improved as opposed to either the relative or absolute amount of dollars expended in the activity.

Current Deductibility of Environmental Remediation is an Appropriate Tax Treatment

The proper application of the repair versus improvement case law leads inexorably to the conclusion that environmental remediation costs, as a general matter, are not subject to capitalization.[5] Regardless of the current law, however, sound tax policy dictates that environmental remediation costs should be deductible no later than the tax year in which incurred.

The capitalization rules seek to require those expenses having a significant long-term future benefit to be matched with the income stream that is expected to be generated in the future.[6] Environmental remediation generally results from past activities of a business and from the earning of income in prior years. It would be irrational to require such expenses to be capitalized merely because they are significant in amount and bunched into a short period of time as a result of a remediation program. A far greater distortion would result from a capitalization requirement than from permitting a deduction for these expenses in the year incurred.

Because these expenditures relate to the earning of income in prior periods, a theoretically correct approach would provide for a deduction in the year in which the condition requiring remediation arises. This approach has been adopted by Congress with respect to certain qualified mining reclamation and solid waste disposal costs under section 468 of the Code. Similarly, the Financial Accounting Standards Board is currently considering a proposal to affirmatively require companies to accrue for financial reporting purposes a "loss contingency" for anticipated environmental liabilities.[7] It is possible that concerns regarding the time value of money may make it infeasible for Congress to enact such a statutory scheme for environmental remediation. Because these expenditures do not produce a future income stream, however, it is manifest that a far greater distortion would result from a capitalization requirement than permitting a current deduction for environmental remediation costs.

Present law provides several relevant factors for distinguishing between a repair cost and a capital improvement. These factors appropriately relate to the nature of the expenditure in relation to the value and functioning of property used in the taxpayer's business. Although these factors have generally been applied uniformly to all activities, Congress has on occasion waived these tests in order to provide specific incentives for certain types of business activities.[8] In these situations, the expenditures incurred in connection with a specified type of activity are deemed to be currently deductible in all cases and the ordinary criteria are waived.

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[5] The Internal Revenue Service has recently issued two informal technical advice memoranda concluding that certain environmental remediation costs must be capitalized. See TAM 9315004 (Dec. 17, 1992) (requiring capitalization of PCB contaminated soil remediation); TAM 9240004 (June 29, 1992) (requiring capitalization of asbestos insulation removal). Due to the strong consensus among taxpayers that the law was misapplied in these TAMs, the IRS has indicated that the TAMs are being reconsidered.

[6] Indopco, Inc. v. Commissioner, 112 S. Ct. 1039 (1992).

[7] Emerging Issues Task Force, Issue 93-5, Minutes of March 16, 1993 Meeting.

Environmental remediation is a significant public policy concern today. As a result of increasingly stringent legal requirements, the financial burden of environmental remediation on private industry is becoming heavier and heavier. At the same time, environmental advocacy groups have an interest in maximizing the amount of environmental remediation effort. A tax policy that increased the after-tax cost of environmental remediation by requiring capitalization would only frustrate and delay these environmental remediation efforts. Instead of providing a less favorable tax treatment, and thus a disincentive for faster and more comprehensive voluntary and involuntary environmental remediation, these environmental advocacy groups should logically support specific tax incentives to hasten these efforts. (This coalition is not promoting new incentives, recognizing the revenue implications.)

Legislation that would require capitalization of environmental remediation would subject these activities to less favorable tax treatment than other business activities. Given the extent and nature of the environmental costs issue, public policy, would dictate that it is appropriate at a minimum to allow these activities to remain subject to the same capitalization criteria as all other activities.

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[8] E.g., section 174 (research and experimentation); section 263(c) (intangible drilling and development costs).

STATEMENT OF MICHAEL F. SOLOMON, PARTNER, IVINS, PHILIPS & BARKER, WASHINGTON, D.C.

Chairman RANGEL. Mr. Solomon.

Mr. SOLOMON. Good morning, Mr. Chairman, I am not before this subcommittee today to argue why expensing environmental remediation costs makes good policy. Certainly, encouraging the cleanup of our environment is an important national goal.

The point I want to make is that Congress should not retroactively change existing law to the detriment of taxpayers undertaking important cleanup activities in the guise of a clarification of the law.

I have three very brief comments on this subject that will augment my written testimony, that I submitted the other day, and ask be admitted for the record.

First, current law, as reflected in a long line of decided cases and in the Treasury's own regulations, stands clearly for the point that most environmental remediation expenses are deductible not capitalizable. As Mr. Hock has just pointed out, they are deductible either as repair expenses, or under the theory of properly matching the income of the taxpayer derived in prior periods against the costs of those prior periods.

Taxpayers who made higher profits over the years because their production expenses were not incumbered with the cost of preventing pollution, now must pay these costs, and they are properly matched against the income in these prior periods.

The second point involves the Internal Revenue Service, which has issued two recent technical advice memoranda, taking a position contrary to this great weight of authority on the subject and require the expenses incurred in two very common environmental remediation situations to be capitalized. The rationale used by the Service to justify their position is weak, is inconsistent, even between the two technical advice memoranda, and even the Service has questioned its own conclusions by providing on the face of the last technical advice that it may not stand behind the legal conclusions in that submission since it was continuing to restudy its position.

And well, they should restudy, because that technical advice memoranda and the other one cannot be reconciled with 67 years of precedent. This latter technical point is dealt with in detail in my written submission.

My final point, my third point, really is a question. What should this Congress and this committee do? If Congress clarifies the law by accepting the Service's technical advice memoranda as the law, it will have effectively changed the law retroactively. It will also have pulled the rug out from taxpayers who have spent hundreds of millions of dollars in good faith, relying on accepted interpretations of existing precedent, expecting to be able to deduct these remediation expenses.

This Congress just went through a very painful debate on retroactive tax legislation. If this Congress accepts the Service's technical advice memoranda as current law and clarifies current law as requiring capitalization of these environmental remediation activities, then the possible retroactive effect of any such clarification will be much more significant than OBRA 1993.

Chairman RANGEL. You don't have any problem if it is prospective?

Mr. SOLOMON. Prospective? Obviously, this Congress can decide to change the law prospectively. I only have a problem in the sense of whether that is a viable policy goal for Congress which, if it changes the law prospectively, would have some chilling effect presumably on this remediation activity.

Chairman RANGEL. We have already taken the heat for retroactive.

Mr. SOLOMON. Yes, sir.

In closing, Chairman Rangel, I should just say that I don't believe that this subcommittee should allow a retroactive change to be clothed as a so-called "clarification." And with that, I thank you.

Chairman RANGEL. Thank you.

[The prepared statement follows:]

STATEMENT OF MICHAEL F. SOLOMON
PARTNER, IVINS, PHILLIPS & BARKER
Before the House Subcommittee on Select Revenue Measures
Concerning the Federal Income Tax Treatment of
Environmental Remediation Expenditures

Mr. Chairman Rangel and members of the Select Revenue Measures Subcommittee, on behalf of my firm and its clients generally, my testimony addresses the limited question of the proper federal tax treatment to be given environmental remediation expenditures under present law. I believe that I am qualified to address this subject since I have been engaged exclusively in the practice of tax law for over seventeen years; I have written articles and handled controversies related to this question of the proper tax treatment to be accorded environmental remediation costs; and I taught for nine years the income tax accounting course at the graduate division of the Georgetown University Law Center which dealt with, *inter alia*, distinguishing between capital and expense items.

The stated intent of the Subcommittee, as set forth in the Joint Committee staff description of this proposal, is to clarify the treatment of environmental remediation costs by specifying which costs must be capitalized.[1] Alternatively, the Subcommittee proposal states that it may require the capitalization of all environmental remediation costs and the amortization of such capitalized costs over a uniform period. I intend to leave for others the reasons why the latter alternative course of action is bad policy. It is a self-evident proposition that providing taxpayers a deduction for the costs of environmental remediation costs encourages such remediation efforts. What is not self evident, however, from the Joint Committee staff description is that current law, the law that this Subcommittee intends to clarify, provides for the deduction of most environmental remediation costs.[2] In clarifying this law, it is incumbent on this Subcommittee to reach this same conclusion, since the results of pending audits and the plans of numerous taxpayers currently undertaking environmental remediation projects would be unfairly affected were this Subcommittee to reach a different conclusion. Also, any clarification will serve to establish the proper revenue baseline against which any change in law on this subject would validly be measured. If the treatment available under current law is misinterpreted by this Subcommittee, the economic and policy implications of any change in law that may be proposed will be seriously flawed.

The balance of my testimony will address the major areas of the Internal Revenue Service's misunderstanding of the law on this subject as reflected in two very recent technical advice memoranda issued by the Service.[3] A more complete discussion of how environmental remediation costs are properly treated under current law can be found in a September 17, 1993 letter to Stuart L. Brown, Internal Revenue Service Associate Chief Counsel (Domestic), that I jointly authored with Claude B. Stansbury of my firm.

It is my opinion that the Internal Revenue Service has seriously misinterpreted the applicable law in five important areas: (1) the standard for determining whether an expenditure materially adds to value; (2) the scope of the so-called "plan of rehabilitation" doctrine; (3) the relevance of indirect and incidental effects of a cleanup expenditure on the taxpayer's operations; (4) the relevance of an expenditure's permanence; and (5) the proper focus of inquiry in examining any cleanup expenditure.

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[1] Staff of the Joint Committee on Taxation, DESCRIPTION OF CURRENT REVENUE PROPOSALS 72-74, (JCS-12-93), Sept. 20, 1993.

[2] Significantly, we note that the *Description of Current Revenue Proposals* prepared by the Staff of the Joint Committee on Taxation addresses only the Internal Revenue Service's analysis as set forth in two recent technical advice memoranda without any substantial analysis of the opposing interpretation of the same and other authorities. *Id.* at 72-74.

[3] Tech. Adv. Mem. 924004 (June 29, 1992) (regarding removal of asbestos insulation) (hereinafter "Asbestos TAM"); Tech. Adv. Mem. 93150004 (Dec. 17, 1992) (regarding remediation of polychlorinated biphenyl contamination) (hereinafter "PCB TAM").

The result of this misinterpretation of the law is an over-inclusive requirement that taxpayers capitalize environmental remediation expenditures which will have the effect of producing a distortion of their taxable incomes. Capitalization and cost recovery through depreciation or amortization is a tax accounting concept designed to match the deduction of costs incurred with the income produced by incurring such costs.[4] This "matching" principle requires that where an expenditure merely repairs an asset to its pre-repair-necessitating-event operating condition, the cost of any such repair should be matched against the current income of the taxpayer, since the full cost of the underlying asset is already being depreciated or amortized over the asset's productive life. This "matching" principle also requires that where an expenditure creates nothing of value which will be used or consumed in the production of future income, there is neither reason nor justification for capitalization, since the income against which such costs should properly be matched was reported by the taxpayer in prior taxable periods. Accordingly, while the Service has twice ruled that environmental cleanup costs are capital expenditures under current law, the tax accounting rules, the Service's own regulations, and the weight of decided cases all require one to conclude that most environmental remediation expenditures, including those analyzed in the two Service TAMs, are currently deductible under present law.

I. THE PROPER STANDARD FOR DETERMINING WHETHER AN EXPENDITURE MATERIALLY ADDS TO VALUE.

The initial focus of the tax accounting issue presented by environmental remediation expenditures is whether such expenditures qualify as repairs which are ordinarily deductible under section 162(a) and Treasury regulations section 1.162-4. Treasury regulation section 1.162-4 permits the current deduction of the "cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition." Section 263(a) of the Code requires capitalization of expenditures which provide enduring benefits to the taxpayer, including "any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." I.R.C. § 263(a)(1).

The primary definitional ambiguity in applying these general statutory and regulatory rules for distinguishing between capital and expense items is the determination of whether an expenditure materially adds value. The courts have long recognized that any properly performed repair adds value when the base reference is the value of the property after the onset of the condition necessitating repair. Accordingly, courts have consistently held that only repair expenditures which materially add to the value of property as compared to the value of the property before the onset or occurrence of the condition necessitating repair are properly capitalized (the "*Plainfield-Union* test").[5]

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[4] *Indopco, Inc. v. Commissioner*, ____ U.S. ____, 112 S. Ct. 1039, 1043 (1992) ("through [sections 162, 167 and 263], the Code endeavors to match expenses with revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes."); *Commissioner v. Idaho Power*, 418 U.S. 1, 16 (1974); *Massey Motors, Inc. v. United States*, 364 U.S. 92, 104 (1960); *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376, 1379 (11th Cir. 1982); *Hertz Corp. v. United States*, 364 U.S. 122, 126 (1960).

[5] *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333, 338 (1962), *nonacq.*, 1964-2 C.B. 8; *Oberman Manufacturing Co. v. Commissioner*, 47 T.C. 471, 483 (1967), *acq.*, 1967-2 C.B. 3. *Illinois Merchant Trust Co. v. Commissioner*, 4 B.T.A. 103, 106-107 (1926), *acq.*, V-2 C.B. 2; *Midland Empire Packing Co. v. Commissioner*, 14 T.C. 635, 641 (1950), *acq.*, 1950-2 C.B. 3; *Niagara Mohawk Power Corp. v. United States*, 558 F.2d 1379, 1387 (Ct. Cl. 1977).

While this standard for determining whether an expenditure materially adds to value is straight-forward, rational, and supported by the great weight of judicial authority, the Service has attempted to distinguish the *Plainfield-Union* test in both the Asbestos TAM and in the PCB TAM. In the two cleanup TAMs, the Service rejected each taxpayer's reliance on *Plainfield-Union* on at least four grounds: (1) that the Tax Court's reasoning was only applicable in cases involving so-called "progressive deterioration"; (2) that the *Plainfield-Union* holding is fact specific and is but one measure of addition to value; (3) that the *Plainfield-Union* test is inapplicable to repairs of "latent" defects, *e.g.* use of a hazardous material like asbestos; and (4) that all expenditures mandated by law or regulation are *per se* capital expenditures. Each of these grounds is against the weight of the available authorities.

A. Progressive Deterioration is irrelevant to *Plainfield-Union* test.

The question of whether the damage being repaired is the result of progressive deterioration or of a sudden occurrence is a red herring. Cases involving both circumstances are abundant. *E.g.*, *Midland Empire Packing Co.*, 14 T.C. at 641 (sudden onset); *Illinois Merchant Trust Co.*, 4 B.T.A. at 107 (sudden onset); *Plainfield-Union Water Co.*, 39 T.C. at 338 (progressive deterioration). *See also Oberman Mfg. Co.*, 47 T.C. at 483 (latent defect, onset neither sudden nor progressive).

Ironically, the Service presented exactly the opposite argument in *Plainfield-Union*, an argument that was rejected by the Tax Court in no uncertain terms. *Plainfield-Union Water Co.*, 39 T.C. at 340 ("We do not agree that the deduction in the instant case requires a relatively sudden, unexpected, or unusual external factor which results in casualty damage."). The Tax Court's point was not that "progressive deterioration" was a necessary condition for deduction, but rather that the factor of sudden versus progressive onset was irrelevant to the question of whether a repair expense is currently deductible or a capital expenditure.

B. The *Plainfield-Union* test is the only standard and is not fact specific.

The Service's conclusion that the *Plainfield-Union* test is fact specific and but one measure of additions to value is unsupported in the case law.[6] The Service's reliance upon the Tax Court's decision in *Wolfsen Land & Cattle Co. v. Commissioner*, 72 T.C. 1 (1979), is misplaced. The decision in *Wolfsen* only supports the proposition that repairs which are in the nature of replacements and which arrest gradual deterioration and appreciably prolong a property's useful life, are capital expenditures. This is hardly a novel holding in light of the Treasury regulation's twice repeated provisions establishing that such expenditures are capital.[7] Accordingly, outside of the context of repairs in the nature of replacements arresting deterioration and prolonging useful life, the *Wolfsen* decision has no significance.

More importantly, this decision does not address the proper standard for determining whether an expenditure materially adds to value and does not undermine or provide an alternative to the long established *Plainfield-Union* test. In fact, in *Wolfsen*, the Tax Court cited its earlier decision in *Plainfield-Union* with approval. *Wolfsen*, 72 T.C. at 16. More to the point, the Tax Court also restates the holding in the seminal case establishing the so-called "*Plainfield-Union*" test, *Illinois Merchant Trust Co.*, 4 B.T.A. 103, with approval. *Wolfsen*, 72 T.C. at 15.

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[6] PCB TAM (citing *Wolfsen Land & Cattle Co. v. Commissioner*, 72 T.C. 1 (1979)).

[7] Treas. Reg. § 1.162-4 ("Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall . . . be capitalized."); Treas. Reg. § 1.263(a)-1(a)(2) (treating as capital "[a]ny amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made in the form of depreciation, amortization, or depletion.").

In contrast to the Service's analysis, *Wolfsen* only stands for the proposition that there need be no addition to value, in the *Plainfield-Union* sense, to properly require capitalization where another provision in the Code or Treasury regulations establishes an independent basis for capitalization.

Thus, in the context of measuring an expenditure's effect on an asset's value, the Service's conclusion that "if the *Plainfield-Union* 'increase in value' test was the only factor used in determining whether an expenditure should be categorized as a deductible repair or capital expenditure, then any replacement of a capital asset would also be deductible", is self-evidently wrong. PCB TAM. Under existing Treasury regulations both: (1) a replacement arresting deterioration and appreciably prolonging life; and (2) a replacement restoring property or making good the exhaustion of property for which an allowance has been made, are capital expenditures whether or not they produce any increase in the underlying property's value. Treas. Reg. § 1.162-4; I.R.C. § 263(a)(2). Nevertheless, the *Plainfield-Union* test remains the only standard for determining whether a cost incurred by a taxpayer with respect to property so materially adds to its value as to constitute a capital expenditure.

C. The *Plainfield-Union* test is applicable to repairs of latent defects.

The Service has also argued that the *Plainfield-Union* test is inapplicable to repairs of latent defects as it is "impossible to value the asset prior to the existence of the [defect]." Asbestos TAM. This line of reasoning is at odds with the available judicial precedents interpreting the Code and Treasury regulations. For example, in *Oberman Mfg. Co.*, considerable expenditures made to insert an expansion joint down the length of a leased building's original roof, which was prone to thermal cracking, were held deductible. 47 T.C. at 483. The Tax Court, applying the *Plainfield-Union* test, held that the insertion of the expansion joint merely restored the roof to its ordinarily efficient operating condition and did not materially add to the value or useful life of the underlying asset, the building, notwithstanding that the expenditure eliminated the need to perform frequent spot repairs in the future, *i.e.* the latent defect. *Ibid. See also Midland Empire Packing Co.*, 14 T.C. at 641 (concrete lining in basement cold storage room added to prevent oil seepage stopped groundwater seepage which had existed throughout taxpayer's use of the building).

In the Asbestos TAM, the Service rejected the taxpayer's argument that the baseline for measuring any incremental addition to value should have been the value of the equipment "before asbestos was known to be a health hazard." Asbestos TAM. The taxpayer's argument correctly states the rule which may be derived from numerous decisions. In *Plainfield-Union*, the removal of a tar-lining and its replacement with a cement lining in the utility's cast iron water main was made necessary by a switch from neutral well water to more acidic river water. In short, in *Plainfield-Union*, a change in the underlying circumstances rendered the existing lining unsuitable to the continued transportation of water. The Tax Court rejected the Service's argument that the addition of the cement lining added value to the water main or adapted it to a new use. 39 T.C. at 338. The switch to a more acidic water source which rendered the original tar-lining unsuitable is little different from the discovery that a piece of equipment's original insulation poses a health hazard which can be abated by replacing it. In each case the original component became unsuitable in light of later developments and was replaced without adapting the underlying property to a new use. Thus, repairs involving latent defects only restore ordinary operating efficiency of the asset to its inherent operating efficiency in its intended use.

D. Compliance with governmental directives does not mandate capitalization.

Finally, the Service has rejected the *Plainfield-Union* test in situations in which the taxpayer's "repair" is in response to a law or regulation. The Service appears to have adopted a *per se* capital rule for any remediation expenditure made to comply with environmental or worker safety laws. There is little if any authority for this position. Each of the cases cited and relied upon by the Service in the two TAMs would have been capital expenditures in the absence of the factor of governmental compulsion.[8]

The unimportance of the factor of governmental compulsion is also evident in the analysis employed by the United States Court of Claims (now the Court of Federal Claims) in *RKO Theatres, Inc.* and by the Tax Court in *Hotel Sulgrave, Inc.* and in *Blue Creek Coal, Inc.*, each of which tested the current deductibility of the compelled expenditures under the requirements set forth in the Treasury regulations and found them to be improvements rather than repairs.[9] In none of these decisions is there any hint of a *per se* capitalization rule.

In contrast to the Service's cited authorities, which are at best ambiguous, numerous authorities have held an expenditure compelled by law to have been a currently deductible repair. *E.g.*, *Midland Empire Packing Co.*, 14 T.C. at 641 (taxpayer installed a concrete lining in a basement cold storage room to avoid forced shut down at direction of federal meat inspectors); *Regenstein v. Edwards*, 121 F. Supp. 952, 953-54 (M.D.Ga. 1959) (installation of steel beams and column required by city inspector held deductible as repair); *Commodore, Inc. v. Commissioner*, 46 B.T.A. 718 (cost of replacing loose stone cornices with copper sheeting, pursuant to a city's safety directive, was a currently deductible repair expense), *aff'd*, 135 F.2d 89 (6th Cir. 1943).

II. THE PROPER SCOPE OF THE "PLAN OF REHABILITATION" DOCTRINE.

The judicially crafted "plan of rehabilitation" doctrine is properly used to require otherwise deductible repair expenditures to be capitalized when incurred: (1) contemporaneously with capital expenditures relating to the same property or properties; and (2) pursuant to a common plan for the permanent improvement, betterment, addition of value, or prolongation of life of the underlying property.[10] Stated differently, the "plan of rehabilitation" doctrine provides a broom permitting the Service and the courts to sweep up ordinarily deductible repair expenditures along with the capital expenditures to which they are integrally related by a common plan.

However, in the PCB TAM, the Service relied upon the "plan of rehabilitation" doctrine to support its ruling requiring capitalization of integrated and extensive repairs, no part of which would constitute a capital expenditure if incurred separately.[11] This unsupported expansion of a narrow judicial doctrine goes far beyond the narrow parameters of the doctrine's two-pronged rule of application. In short, the plan of rehabilitation doctrine does not support treating a series of repairs with no related capital spending as a capital expenditure.

The Service's discussion of the plan of rehabilitation doctrine in the PCB TAM relies primarily upon the decision of the Court of Appeals for the Tenth Circuit in *Mountain Fuel Supply Co. v. United States*, 449 F.2d 816 (1971), *cert.*

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[8] *Teitlebaum v. Commissioner*, 294 F.2d 541 (7th Cir. 1961) (replacement of direct current wiring with alternating current wiring), *cert. denied*, 386 U.S. 987 (1962), *reh. denied*, 369 U.S. 842 (1962); *RKO Theatres, Inc. v. United States*, 163 F.Supp. 598 (Ct. Cl. 1958) (installation of fire exits); *Hotel Sulgrave, Inc. v. Commissioner*, 21 T.C. 619 (1954) (installation of fire suppression sprinkler system); *Beaven v. Commissioner*, 6 T.C.M. (CCH) 1344 (1943) (replacement of existing oil fired furnace with coal burning furnace); *Cerda v. United States*, 84-1 U.S.T.C. ¶ 9,490 (N.D.Ill. 1984) (variety of expenditures arresting deterioration and prolonging useful life of rental property); *Blue Creek Coal, Inc. v. Commissioner*, 48 T.C.M. (CCH) 1504 (1984) (addition of driver cabs on bulldozers).

[9] *RKO Theatres, Inc.*, 163 F.Supp. at 602; *Blue Creek Coal, Inc.*, 48 T.C.M. (CCH) at 1508; *Hotel Sulgrave, Inc.*, 21 T.C. at 621.

[10] *Moss v. Commissioner*, 831 F.2d at 833, 840 (9th Cir. 1987).

[11] PCB TAM at n.3 & accompanying text.

denied, 405 U.S. 989 (1972). The Tenth Circuit's decision in *Mountain Fuel Supply Co*. involved expenditures which not only appreciably extended the useful life of the underlying asset, a natural gas pipeline, but also improved upon the original asset by doubling its operating pressure and thus materially increasing its carrying capacity. 449 F.2d at 819. Thus, having found a purpose and effect in certain of the reconditioning expenditures which mandated capitalization, the Tenth Circuit properly required the taxpayer to capitalize all costs associated with its pipeline reconditioning operations under the plan of rehabilitation doctrine. *Ibid*. 449 F.2d at 820.

The Service's analysis of this decision in the PCB TAM seriously misstates this holding, contradicts the opinion's express language, and is irreconcilable with the facts presented in the case. PCB TAM at n. 3 ("The fact of whether the pipeline's useful life was extended, however, was a separate issue from whether the general plan of rehabilitation doctrine required the costs to be capitalized."). Notwithstanding the Service's discussion of this decision, it is impossible to separate the Tenth Circuit's consideration of the plan of rehabilitation doctrine from its conclusion that the expenditures incurred to recondition the pipeline, much of which was admitted to be capital, had improved the property and prolonged its life. Moreover, it is impossible to find support for the Service's summary of the decision in light of the fact that the circumstances before the court did not involve a situation in which no part of the total expenditures would have been a capital item if considered separately. Indeed, there exists no authority for the proposition that deductible repair expenditures may be treated as capital expenditures under the plan of rehabilitation doctrine where those deductible repairs are not made in conjunction with an overall plan including capital improvements.[12]

In contrast to the Service's understanding of the plan of rehabilitation doctrine, the existing decisional law establishes that two factors are required for the doctrine's proper application: (1) otherwise deductible repair expenses incurred contemporaneously with capital expenditures and with respect to the same property; and (2) a common plan for the improvement, betterment, addition of value or prolongation of life of the underlying property pursuant to which both the repair and the capital expenditures are incurred.[13]

III. RELEVANCE OF INDIRECT AND INCIDENTAL BENEFITS RESULTING FROM A CLEANUP EXPENDITURE ON A TAXPAYER'S OVERALL OPERATIONS.

In both the Asbestos TAM and the PCB TAM, the Service relied extensively upon the existence of incidental and indirect future benefits to support its ruling that the remediation expenditures in question should be capitalized as improvements or betterments or expenditures adding to value. Asbestos TAM (value increased through reduction in human health risks and associated risk of civil liability; equipment improved by eliminating the need to undertake OSHA mandated safety precautions each time equipment is serviced and by reducing down-time); PCB TAM ("...betterments include, but are not limited to, transforming sections of contaminated land into land that is no longer contaminated, avoiding further government penalties by bringing the properties into compliance with government regulations, providing a safe environment for workers and adjoining property owners, increasing the marketability of the properties . . .").

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[12] *See Moss, supra*, 831 F.2d at 839 ("To our knowledge, every case in which the rehabilitation doctrine has been applied to date has involved substantial capital improvements and repairs to the same specific asset, usually a structure in a state of disrepair.").

[13] *Kaonis v. Commissioner*, 37 T.C.M. (CCH) 792, 796 (1978), *aff'd mem*., 639 F.2d 788 (9th Cir. 1981) (permitting current deduction of repair expenses not related to capital expenditures by a common plan or rehabilitation); *Keller Street Dev. Co. v. Commissioner*, 37 T.C. 559, 568 (1961) (capital expenditures made by the taxpayer to increase its brewery's productive capacity found not to be the type which indicate the existence of a general betterment program, contemporaneous repair items deductible), *acq*., 1962-2 C.B. 5, *aff'd in part and rev'd in part on other grounds*, 323 F.2d 166 (9th Cir. 1963).

In the Asbestos TAM, the Service relies upon the decision of the United States Claims Court in *Electric Energy, Inc. v. United States*, 13 Cl. Ct. 644 (1987). In *Electric Energy*, the taxpayer, a public utility, undertook a multi-million dollar four-year program to substitute all of the horizontal tubing elements within a power plant's boilers' heat-exchanging "economizers."[14] The original economizers were installed in 1953 and used "finned" tubes designed to increase the total heat-exchanging surface area. *Id.* at 662-63. The taxpayer's substitution program began in 1977. Because of the original tube array and the use of finned tubes, unexpected accelerated erosion problems developed resulting in ever increasing repair expenditures and forced stoppages of the related boiler.[15]

The taxpayer in *Electric Energy, Inc.* elected to undertake the phased replacement of the six original economizers with a redesigned model which included extra-tube length, finless tubing and a new tube array. *Id.* at 664. Characterizing the economizers as but a component of the whole power-plant's boilers, the taxpayer argued that the replacement program did not add to the boilers' useful lives, increase their value, or adapt them to a new use. *Id.* at 665. The Claims Court, however, concluded that the economizers were separate and distinct assets and that the tube replacements, constituting roughly 87% of the entire economizer, substantially prolonged the useful life of the economizer. *Id.* at 666 ("The prolonged useful life of the economizers alone supports capitalization. The correction of a defect which contributes to prolonging the life of equipment is a replacement, not a repair, and must be capitalized.").[16]

While it is true that the economizer replacements in *Electric Energy, Inc.* implemented a redesign which was anticipated to reduce the erosion problem associated with the original tube array of the economizers, an obvious operating efficiency improvement, this factor was not the basis of the Claims Court's holding and probably would not have required capitalization in the absence of a substantial prolongation of the economizers' useful lives. *Electric Energy, Inc.*, 13 Cl. Ct. at 667 ("Overall the court deems this evidence more probative of prolonging the life of the economizers than constituting a betterment.").

In short, *Electric Energy, Inc.*, does not support the Service's proposition that replacements that produce incidental operating efficiencies unrelated to the inherent operation of the repaired asset, are capital expenditures. Indeed, ample decisional law establishes that an expenditure which permits a taxpayer to avoid future expenses does not create a capital asset.[17] Rather, only where the replacement produces increased operating efficiency of the asset which is a material improvement over and above its ordinarily efficient operating efficiency or appreciably prolongs the life of the underlying asset, as in *Electric Energy, Inc.*, is capitalization justified. Thus, in *Midland Empire Packing Co.*, 14 T.C. 635, where the taxpayer's purpose was simply to restore the former utility of its meat-packing plant's cold storage room by arresting oil seepage, the fact that the repairs incidentally improved the room's utility over its prior condition by stopping all groundwater seepage, was ignored: the "improvement" was an unintended and unavoidable result of preventing the seepage of oily water into the room and resulted in no improvement in its utility in the context of the taxpayer's continuing business activities. *Midland Empire Packing Co.*, 14 T.C. at 641. The same point can be made about the addition of an expansion joint in a building's roof in *Oberman Mfg. Co.*, 47 T.C. 471, and about a taxpayer's expenditures to grade and fill a parcel of land as a means of eliminating a drainage problem caused by an adjoining landowner in *Southern Ford Tractor Co. v. Commissioner*, 29 T.C. 833 (1958).[18]

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[14] An economizer, essentially a large tightly-packed array of nearly nine miles of thin metal tubing, is an "add-on" component in a power plant boiler which increases the plant's overall electric generating efficiency by pre-heating steam feed-water with waste gases from the furnace. *Electric Energy, Inc.*, 13 Cl. Ct. at 662.

[15] This is the fact upon which the Service pins its application of the *Electric Energy* decision to asbestos removal expenditures. Asbestos TAM ("By removing asbestos, the taxpayer increases the value of its assets because it eliminates the need to take such [OSHA and state mandated] precautions. Therefore, similar to the petitioner in *Electric Energy*, the removal of asbestos enhances certain operating efficiencies.").

[16] This holding simply applies the rule that "repair" expenditures which are "in the nature of a replacements," must be capitalized where the expenditures "arrest deterioration and appreciably prolong the life of the property." Treas. Reg. § 1.162-4. *Compare Electric Energy, Inc.*, 13 Cl. Ct. 644 with *Gloucester Ice & Cold Storage Co. v. Commissioner*, 19 T.C.M. (CCH) 1015 (1960) (cost of replacing corroded salt water pumps in ice making plant which did not appreciably prolong life were deductible). *See also Phillips & Easton Supply Co. v. Commissioner*, 20 T.C. 455 (1953) (replacement of floor after 46 years in service, old floor was so deteriorated further repairs were impractical, replacement floor had appreciably longer useful life); *Hudlow, Jr.*, 30 T.C.M. (CCH) at 923 ("forklift trucks . . . were substantially worn out, and . . . work done . . . was in the nature of an overhaul, which served to prolong the life of the machines and to increase their value."); *Almac's Inc. v. Commissioner*, 20 T.C.M. (CCH) 56, 59 (1971) (replacement of boiler tubing after 27 years in service appreciably extended the useful life of the boiler); *Ruane v. Commissioner*, 17 T.C.M. (CCH) 865, 871 (1958) (relining coke ovens with glass brick gave oven new life expectancy of three to four years, roughly equal to their original life expectancy).

The Service cites no direct authority, nor has any been found, for the proposition that incidental future benefits are sufficient grounds for capitalizing an expenditure, particularly in cases where the purpose of the taxpayer in incurring any such expenditure is not to produce an amorphous future intangible benefit but rather to place a damaged operating asset in a repaired condition.[19]

IV. A REPAIR'S PERMANENCE IS IRRELEVANT TO CAPITALIZATION.

In the Asbestos TAM, the Service also relied upon the Tax Court's decision in *American Bemberg Corp.*, 10 T.C. 361, 376 (1948), *aff'd*, 177 F.2d 200 (6th Cir. 1949) for the proposition that the duration of the effect of the expenditure, *i.e.* whether the repair is permanent, is a significant factor in determining whether an expenditure is deductible as a repair expense.[20] Though the court discusses the remediation of "intermediate" consequences, the holding in no way relies upon the fact that the expenditures in question were impermanent. To the contrary, though the taxpayer was required to maintain vigilance for future areas of subsidence, the former areas of subsidence were permanently repaired. *American Bemberg Corp.*, 10 T.C. at 376.

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[17] Moreover, established decisional law makes clear that where a one-time expenditure reduces future deductible expenses, but does not create or enhance a separate capital asset, the one time expenditure is deductible. *Indemnity Insurance Co. v. Commissioner*, 237 F.2d 901 (7th Cir. 1956) (payments to terminate unfavorable agency agreement deductible); *Cleveland Allerton Hotel v. Commissioner*, 166 F.2d 805 (6th Cir. 1948) (payment styled liquidated damages for release from onerous contract deductible as no capital asset was acquired); *Stuart Co. v. Commissioner*, 195 F.2d 176 (9th Cir. 1952) (payment to obtain release from above market fixed price supply contract deductible); *Montana Power Co. v. United States*, 171 F.Supp. 943 (Ct. Cl. 1959) (same). *Compare Darlington-Hartsville Coca Cola Bottling Company, Inc. v. United States*, 393 F.2d 494 (4th Cir. 1968) (payment by bottlers to Coca Cola Company to terminate business arrangement involving middlemen was for acquisition of a capital asset, the right to purchase syrup directly from Coca Cola Company at potentially lower prices); *Rodeway Inns of America v. Commissioner*, 63 T.C. 414 (1974) (franchisor's payment to terminate a franchisee's exclusive rights to a territory acquired a capital asset, the right to expand business into the territory). These cases, and the avoidance of future maintenance expenses by incurring a one-time repair expenditure, are distinguishable from a mere prepayment of future expenses or the establishment of a reserve for future expenses which will be incurred in later taxable periods.

[18] *See also E.V. Scott v. Commissioner*, 38 T.C.M. (CCH) 115 (1979) (installation of sprinklers to raise water table under a building and stabilize its foundation was deductible repair: lawn-watering as an end was not the taxpayer's purpose); *J. H. Collingwood v. Commissioner*, 20 T.C. 937, 942 (1953) (cost of grading earthen terraces on hilly farmland to reduce soil erosion caused by use of increasingly modern agricultural techniques was deductible repair).

[19] *See* PCB TAM (citing *Indopco, Inc. v. Commissioner*, ___ U.S. ___, 112 S. Ct. 1039, 1045 (1992), for the proposition that sections 162 and 263 "envision an inquiry into the duration and extent of the benefits realized by the taxpayer.").

[20] The Asbestos TAM misstates the literal language of the Tax Court's opinion in *American Bemberg Corp., supra*, which refers to "intermediate" consequences rather "immediate" consequences. *American Bemberg Corp., supra*, 10 T.C. at 377. More

More importantly, numerous other authorities directly hold that a repair may be permanent without requiring the expenditure to be capitalized.[21] For example, in *Oberman Manufacturing Co.*, the taxpayer's considerable expenditures to insert a copper-coated wood-framed expansion joint down the length of a leased building's roof were held deductible. *Oberman Mfg. Co.*, 47 T.C. at 483. The repair in *Oberman* was unquestionably "permanent" and resulted in the taxpayer's avoidance of the anticipated need to perform frequent future "spot" repairs, of which it had already performed more than twenty.[22]

Likewise, in *Niagara Mohawk Power Corp., supra*, a public utility, which had experienced a significant number of leaks in the jute packed joints of its cast iron pipelines following the introduction of natural gas in place of manufactured gas, clamped rubber gaskets around leaking joints which rendered the old jute packed joints redundant. 558 F.2d at 1387. The United States Court of Claims held that the clamps did not add value to the pipeline, extend its useful life, or otherwise improve it. The Court of Claims stated:

> A repaired joint obviously represents an "improvement" over a leaking joint, but that is not the test of a nondeductible capital "improvement" within the contemplation of the Code. . . .
>
> . . . It is not surprising that these repairs both eliminated an existing defect, and made it less likely that the defect would again occur at that point. That is the usual purpose, and effect, of any repair.
>
> The fact that the clamp installed to remedy a leak, may outlast the pipeline on which it is installed, does not mean that the originally contemplated useful life of the pipeline has been thereby extended.

Niagara Mohawk Power Corp., 558 F.2d at 1387-88 (emphasis added). As is evident from the language of the opinion set forth above, the focus of judicial inquiry is the expenditure's effect upon the asset being repaired. Where an expenditure improves that asset's essential functions, appreciably prolongs its useful life, or materially adds to its value, the expenditure is capital in nature. However, the fact that the expenditure reduces future maintenance expenditures is not relevant where the expenditure produces no such proscribed effect on the repaired asset as a whole.[23]

In summary, there is no basis for the Service's position that a repair must remedy "immediate consequences" and not provide a "permanent cure."

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importantly, however, the Asbestos TAM misstates the holding of the Tax Court which directly analogized its reasoning to that of the United States District Court in *Buckland v. United States*, 66 F.Supp. 681, 683 (D.Conn. 1946). *Ibid.*, 10 T.C. at 378 (quoting in particular from the decision in *Buckland*, the following, "Defendant's [U.S.] contention appears to be that repairs are only those mending the fabric which recur year to year. This is not consistent with the meaning given "ordinary and necessary" in *Welch v. Helvering, Commissioner*, 290 U.S. 111.").

[21] Although the Service treated its discussion of the enhanced operating efficiency of "avoided future repairs" and the issue of "permanent repairs" as separate issues, they are in fact two sides of the same coin. Nevertheless, for purposes of our testimony, we have addressed these two misstatements of the present law under different headings.

[22] *See also Illinois Merchant Trust Co.*, 4 B.T.A. 103 (permanent repair expenditures deductible).

[23] *See also Kansas City S. Ry. v. United States*, 112 F.Supp. at 164, 165 (Ct. Cl. 1953) ("When a building or a machine is repaired, it is not unusual that the repaired portion is better than and will outlast the parts that have not yet needed repairs.").

V. THE PROPER FOCUS OF INQUIRY IN EXAMINING ANY CLEANUP EXPENDITURE.

The tax rules governing environmental remediation expenditures will, in large part, be affected by the legal distinctions between repairs and capital expenditures and by the application of the matching principle associating income and related expense. However, the decision as to whether certain environmental cleanup expenditures should be treated as currently deductible or as capital expenditures with enduring future benefits will depend upon the perspective which frames the question. If the Service looks for the existence of any future benefit as justifying capitalization, then almost no expenditure, including nearly all environmental remediation expenditures, will escape capitalization. If, however, the focus is on the taxpayer's immediate purpose of repairing assets previously damaged by environmentally unsafe activities and operations, then many, if not most, remediation expenditures will qualify for current deduction. Decisional law establishes that the question is properly framed in the light of the taxpayer's immediate purpose, the physical nature of the work involved, and the effect of the expenditures upon the taxpayer's property in the context of its business operations. *American Bemberg Corp., supra*, 10 T.C. at 376. The taxpayer's purpose is given primary, and often controlling, weight. *Illinois Merchant Trust Co., supra*, 4 B.T.A. at 106; *Oberman Mfg. Co., supra*, 47 T.C. at 482.

The Service's analysis of the available authorities in the two cleanup TAMs does not give due regard to the consideration of the taxpayer's purpose in incurring the remediation expenditures. As a result, the Service has ruled that expenditures plainly incurred to restore business assets to their original ordinarily efficient operating condition are capital in nature, primarily on the basis of incidental, indirect, and inconsequential future benefits which have long been disregarded by the courts in reaching decisions allowing the current deduction of repair expenditures.

CONCLUSION

The Service may be understandably concerned about the enormous amount of environmental clean-up costs waiting to be deducted, but its TAM rulings cannot be squared with the Treasury's regulations, the *Plainfield-Union Water* case, the *Niagara Mohawk Power Corp.* case, *Illinois Merchant Trust Co., Oberman, Midland Empire Packing, Buckland, American Bemberg Corp., Electric Energy, Mountain Fuel Supply, Moss*, and the other cases cited above, no matter how hard the Service tries to distinguish their holdings. If the intent of this Subcommittee is to clarify existing law in this area, then it has no recourse but to determine that environmental remediation expenses of the type presented in the two TAMs and in most common cleanup situations are currently deductible under the rules that currently control the tax result.

STATEMENT OF WAYNE ROBINSON, DIRECTOR OF TAXES, GENCORP, ON BEHALF OF THE COALITION FOR THE FAIR TREATMENT OF ENVIRONMENTAL CLEANUP

Chairman RANGEL. Mr. Robinson.

Mr. ROBINSON. Mr. Chairman, members of the subcommittee, my name is Wayne Robinson, and I am here on behalf of the Coalition for the Fair Treatment of Environmental Cleanup Costs. The coalition is made up of companies representing a wide range of industries, including automotive parts, manufacturing, banking, chemical manufacturing, mining, natural gas production, pharmaceutical manufacturing, and precision tool manufacturing.

We have also submitted a written statement that I ask be inserted in the record.

Chairman RANGEL. Without objection.

Mr. ROBINSON. Cleaning up the environment is a vital and far-reaching national priority, one that every member of this coalition firmly supports. It is an immense task, however. The fair tax treatment of environmental cleanup costs, therefore, is an important issue that concerns either directly or indirectly a great number of U.S. businesses. Thorough cleanups and prompt compliance with our environmental laws are critical if the task of cleaning up the environment is to be successfully completed.

Mr. Chairman, proposals to require companies to capitalize their environmental cleanup costs or to deny their current deductibility would effectively discourage prompt and thorough cleanup and compliance. In addition, such proposals would, for the most part, distort income, thereby violating a fundamental rule of our income tax system.

As you know, a basic rule of our tax law is that the tax deduction for an expenditure should be matched with the income to which it relates. This clearly reflects income. A rule that would require the capitalization of environmental cleanup costs would violate the clear reflections of income rule.

This is because most environmental cleanup costs are backward looking. They relate to past events and to income generated in the past, not to income to be produced in the future.

Consider as an example, a company that disposed of scrap material in a landfill in full compliance with all laws at the time. A few years later, however, the scrap is determined to be a health hazard and must be removed from the landfill and incinerated. To comply with the revised law, the company will incur significant costs to remove and incinerate the scrap.

Clearly, in this example, the cost of this remediation does not reflect or does not relate to the ongoing business of the company. In fact, if the current law had been in effect when the company first disposed of its scrap, the business would have had a higher disposal cost which would have been properly deductible as a legitimate business expense at the time.

We believe it violates the clear reflection of income rule to deny a deduction for these backward looking expenses. It is also inaccurate to suggest that environmental policy is somehow being subverted by allowing a tax deduction for cleanup expenses. Our most important Federal and State remediation laws, including CERCLA, require cleanup on a no-fault basis. Where penalties are imposed by the environmental laws, they are clearly not deductible. The members of this coalition agree with this result.

Capitalization of environmental cleanup costs for tax purposes would materially increase the cost of most cleanup projects. These increased costs will inevitably discourage companies from promptly undertaking new cleanup projects.

The disparate effects of the present proposal become obvious when certain basic facts concerning environmental cleanups are considered:

First, environmental remediation is already very expensive and is becoming increasingly expensive. Between 1984 and 1989, for example, average annual outlays related to CERCLA cleanups nearly tripled. There are approximately 25,000 waste sites under CERCLA alone. Current estimates are that the total cost of cleaning up existing hazardous waste sites will range anywhere from $500 billion to $750 billion over the next 30 years, a substantial impact on companies for some time to come.

Second, most environmental cleanups do not maintain or improve a company's productive capacity or competitiveness. In this context, denying or delaying the tax deduction for environmental cleanup costs will discourage companies from undertaking prompt, thorough cleanup and compliance.

Let me conclude by reiterating that each company in this coalition believes in the importance of cleaning up our environment. We believe that sound tax and environmental policy dictate that the present law treatment that allows a current tax deduction for environmental cleanup cost be continued.

We respectfully request that Congress take whatever steps are necessary to ensure that the tax law continues to encourage prompt and thorough cleanup.

Thank you very much, and I will be happy to address any questions.

Chairman RANGEL. Thank you.

[The prepared statement follows:]

STATEMENT OF WAYNE ROBINSON
ON BEHALF OF THE COALITION
FOR THE FAIR TREATMENT OF ENVIRONMENTAL CLEANUP COSTS
REGARDING PROPOSALS TO CLARIFY THE TREATMENT OF ENVIRONMENTAL REMEDIATION COSTS

Mr. Chairman, members of the Subcommittee, my name is Wayne Robinson. I am here on behalf of the Coalition For The Fair Treatment Of Environmental Cleanup Costs.

The Coalition is made up of companies representing a broad range of industries.[1] Our members are engaged in automotive parts manufacturing, banking, chemical manufacturing, mining, natural gas production, pharmaceutical manufacturing, and precision tool manufacturing, among many other activities. Many of our members are Fortune 500 companies. I am the Director of Taxes at GenCorp. GenCorp is engaged in the manufacture of aerospace, automotive, and polymer products.

Mr. Chairman, the fair tax treatment of environmental cleanup costs is an issue that concerns, directly or indirectly, a vast number of U.S. businesses. It has been estimated, for example, that under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA), alone, there may be as many as 25,000 hazardous waste sites requiring remediation. Yet, CERCLA is only one of over 40 federal statutes (not to mention state statutes) devoted to the objective of remediating environmental contamination and protecting the environment.

Cleaning up the environment is an important and far-reaching national priority, one that every member of this Coalition firmly supports. It is an immense task, however, that will take decades to carry out. Thorough cleanups and prompt compliance with our environmental laws are critical if the task is to be successfully completed.

Mr. Chairman, proposals to require companies to capitalize their environmental cleanup costs or to deny the current deductibility of those costs would effectively *discourage* prompt and thorough cleanup and compliance. In addition, such proposals would, for the most part, distort income, thereby violating a fundamental rule of our income tax system.

In short, such proposals represent unsound environmental policy and, more important from this Subcommittee's perspective, unsound tax policy. I would like briefly to expand on these two points with you today.

I. Capitalization Would Be Contrary To Fundamental And Long Established Tax Rules

Under longstanding federal income tax law, a company is required to capitalize its current expenditures (and, thus, delay deducting the expenditures) if the expenditures will produce future income or benefit for the company. By contrast, expenditures that do not produce a future benefit for the company are deductible. The policy behind this law is simple: it allows the deduction of the expenditure to be "matched" with the income that it produces. The rule is called the "clear reflection of income" rule, and it underlies a large portion of our income tax laws.

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[1] The Coalition's members include: Arkla, Inc., Brush-Wellman, Inc., Delaware North Companies, Eastman Kodak Co., GenCorp, Laidlaw Corporation, Merck & Co., Inc., North American Coal Corporation, Savings and Community Bankers of America, SCM Chemicals, Textron, Inc., Union Carbide Corporation, and Whittaker Corporation.

In most cases, a rule requiring the capitalization of environmental cleanup costs would violate this fundamental clear reflection of income rule. This is because most environmental cleanup costs are "backward looking" -- they relate to past events, and to income that was generated in the past, not to income that will be produced in the future.

To take a simple example, under CERCLA, a company is often required to clean up property that it has never owned or no longer owns. In these circumstances, the cost of the cleanup clearly produces no future income or benefit for the company. Thus, there is no reason to delay the company's deduction for its cleanup cost. Simply stated, there is no future income to "match" the cost against. The cost is a true current cost of doing business and should be deducted accordingly.

Similarly, where a company is required to expend cleanup costs related to operations that have been discontinued by the company, the costs should be currently deductible. Such costs relate to past operations and past income. Again, there is no reason to delay the company's deduction because there is no future income or benefit with which the deduction can be "matched." The cleanup cost is a cost of doing business in the past.

For example, one of the members of our Coalition has a current environmental cleanup liability arising out of various production operations that it discontinued over 20 years ago. Another has a current environmental cleanup liability arising out of operations discontinued over 15 years ago. Many of our members have such liabilities arising out of production operations that they discontinued between five and 10 years ago.

In all of these cases, no future income or benefit will be produced by the company's cleanup costs. The costs relate to an income stream that existed in the past (when the discontinued operations were ongoing). Accordingly, the clear reflection of income rule requires that the cleanup costs be deducted currently.

Even where the property is still in productive use by the company, the cleanup costs related to the property usually have little to do with producing future income or benefit.

For example, one of the members of our Coalition owns contaminated real estate that would be worth approximately $2.5 million in a fully cleaned-up state. The company's best estimate of the cost of cleaning up the real estate is $20 million. It has accrued the $20 million cost as an expense on its financial books (and reduced its reported earnings to its shareholders by this amount). Thus, this company will have to spend $20 million to clean up property that is only worth $2.5 million.

Clearly, this company's cleanup costs are not being expended to produce future income or benefit (no one spends $20 million to obtain $2.5 million of benefits). Just as clearly, the costs should be currently deducted, not capitalized.

As a general matter, the great majority of cleanup expenditures are not incurred in order to produce future benefit. Currently, however, the IRS seems to have a different view. Under the IRS's view, for example, asbestos replacement costs produce future benefits, even where it is acknowledged that the replacement material is *less effective* in the company's operations. We believe that when a company *downgrades* its operations in order to comply with environmental laws, it should not be treated as if it has received a benefit.

Furthermore, in most cases, cleanup expenditures are incurred to remediate the effects of *past* production operations. As I stated previously, cleanup expenditures are predominantly "backward looking" -- they relate predominantly to past income streams. Thus, the long established clear reflection of income rule mandates that the costs be deducted currently.

II. Prompt Cleanups Would Be Discouraged

Capitalization of environmental cleanup costs for tax purposes would materially increase the costs of most cleanup projects (by denying companies a current deduction for their cash outlays related to the projects). These increased costs will inevitably discourage companies from promptly undertaking new cleanup projects. At best, given companies' limited resources in this persistently difficult economy, the increased costs associated with capitalization will encourage companies to delay environmental cleanups for as long as possible.

The disparate effects of the present proposal become obvious when several facts concerning environmental cleanups are considered. First, under CERCLA and many state statutes, companies frequently are required to undertake environmental cleanups when they are not at fault for the underlying environmental contamination. As a result, companies are required to clean up contaminated properties even if the contamination was caused by a prior owner or even if the company was diligent and used state-of-the-art care at the time the contamination occurred. As I mentioned at the outset of my remarks, there are approximately 25 thousand waste sites under CERCLA alone, and, contrary to what some have implied, the cleanup of these sites will not be premised on fault. I should note that where a fine or penalty is imposed on a company in respect of environmental contamination, the amount of the fine or penalty is *not* deductible. Let me emphasize that the members of our coalition agree with this result.

Second, most environmental cleanups do not improve a company's productive capacity, and many cleanups actually reduce productive capacity. Cleanup costs are incurred not because they help the taxpayer's business -- they generally do not -- but because Congress and the various states have declared them to be an important priority. So, while environmental cleanups do produce a societal benefit, they generally do not directly benefit the company that undertakes the cleanup.

Third, environmental remediation is already very expensive and is getting more expensive all the time. Between 1984 and 1989, for example, average annual outlays related to CERCLA cleanups nearly tripled. Current estimates are that the total cost of cleaning up existing hazardous waste sites will range anywhere from $500 billion to $750 billion over the next 30 years. Thus, the costs of cleaning up the environment are already immense and will continue to have a substantial impact on companies for some time to come.

Again, prompt and thorough cleanups are essential if our national objective of remediating the environment is to be met. As matters presently stand, however, companies are asked to engage in cleanups although (1) they frequently are not at fault for the contamination they are required to clean up, (2) their productivity generally does not benefit from the cleanups, and (3) the cleanups are expensive and financially burdensome.

Viewed in this context, the substantial additional costs that would be imposed by proposals to capitalize cleanup expenditures would make it extremely difficult for cleanup projects to compete for limited company resources. Clearly, capitalizing these costs, or denying their deductibility, would significantly *discourage* prompt cleanup and compliance.

III. Conclusion

In conclusion, we believe that any proposal to capitalize the costs of environmental cleanups would have adverse consequences for both the environment and business. The overriding policy objective must be to ensure that environmental cleanups are undertaken in a prompt and thorough manner. The current tax treatment of cleanup costs provides legitimate encouragement to businesses, consistent with longstanding tax principles to act responsibly and clean up such sites promptly and thoroughly. Congress should not change this treatment. Moreover, we respectfully request that Congress take whatever steps are necessary to ensure that the IRS not frustrate this most important policy goal.

Thank you very much Mr. Chairman. I would be happy to address any questions that the Committee might have.

STATEMENT OF FRED J. GENTILE, SENIOR VICE PRESIDENT, THE BROOKLYN UNION GAS COMPANY, REPRESENTING THE COALITION TO ELIMINATE TAX BARRIERS TO ENVIRONMENTAL CLEANUP

Chairman RANGEL. Mr. Gentile.

Mr. GENTILE. Yes, good morning, Mr. Chairman, and members of the committee.

My name is Fred Gentile. I am senior vice president of the Brooklyn Union Gas Co., a gas utility regulated by the New York State Public Service Commission. We provide gas sales and service to 1.1 million customers, the majority of which are residential in the New York City boroughs of Brooklyn, Queens, and Staten Island.

I am pleased to address you briefly today on the matter of whether the tax law treatment of environmental remediation costs should be changed or clarified as a revenue raising measure and on the proposed denial of a tax deduction for amounts paid as compensatory damages in environmental matters.

I ask that my complete statement be submitted for the record, Mr. Chairman.

Chairman RANGEL. Without objection.

Mr. GENTILE. By way of background, I am representing today an ad hoc coalition of companies that share my own company's concern that tax barriers to environmental cleanup be eliminated. The members of this coalition comprise a multi-industry group, including representatives from such industries as manufacturing, consumer products, regulated utilities, timber, transportation, pulp and paper, mining, pipelines, and environmental services.

It is a fact that virtually every business in this country will incur costs of environmental cleanup, if for no other reason than to address historical conditions. Therefore, we are vitally concerned about the matter before this committee.

We are testifying today because we believe it would be a serious mistake, with no conceivable justification to impose arbitrary capitalization and amortization rules that change the present tax law treatment of environmental remediation costs to raise revenues.

Tax simplification and clarification are worthy goals when pursued for their own sake, but they should not be pursued as a means of raising revenue. These two proposals under consideration by this subcommittee would change the current law in a way that would distort income, penalize environmental remediation activities, and thereby reduce or delay those mediation activities.

Thus, we oppose these proposals to raise revenue by changing the treatment of environmental remediation expenditures, because these proposals would harm environmental, economic and tax policies.

From an environmental policy standpoint, the most obvious reason for not increasing the cost of environmental remediation is the goal that underlies the Comprehensive Environmental Response Compensation and Liability Act of 1980, called CERCLA, and other environmental protection laws: Namely, to promote a cleaner environment.

While CERCLA requires cleanup of compromised sites by the responsible party, CERCLA is not self-executing. It is necessary for the government to identify the responsible parties and to successfully pursue a civil claim against them.

A tax proposal that requires more remediation costs to be capitalized would hinder government efforts to secure clean commercial and industrial sites. This is due to a simple economic situation. The resulting higher costs of environmental cleanup would discourage some responsible parties from coming forward to begin remediation in advance of government action.

At the very least, it would cause them to want to delay cleanup efforts and to seek less costly, perhaps less effective means of remediation. Thus, such a proposal would lead to the cleanup of fewer sites within a given period of time.

Clearly, public policy is better served by a tax treatment that does not increase the cost of remediation but rather reduces the incentive for proactive litigation and mitigates the negative externality.

From an economic policy standpoint, any proposal that further burdens the environmental cleanup process merely adds to the already high cost U.S. firms must pay to improve the environment. Such additional costs would have far-reaching impact on the ability of U.S. firms to compete effectively in the global marketplace.

The competitiveness of U.S. businesses has already been severely strained as a result of the cost that will be incurred by business under other environmental laws. It is counterproductive to further increase that cost, thereby reducing the funds available for these remediation activities.

At a time when environmental cleanup is already burdening U.S. firms, enacting a tax on these activities would reduce already scarce reinvestment dollars and would be a self-defeating policy.

From a tax policy standpoint, an arbitrary capitalization rule or a uniformed amortization period for all designated cleanup costs is also undesirable and, I might add, inequitable. Such treatment would not improve on the accurate measurement of income for tax purposes relative to the current law.

Current law recognizes the difference between remediation costs that add value to existing property or increase its productivity or extends its useful life, and those that do not.

This treatment tends to match the expenditures that provide an ascertainable future benefit with income that is likely to flow from that benefit. Moreover, it tends to do so over the period that the affected property will be in service. On the contrary, arbitrary capitalization and amortization rules designed specifically to depart from the more accurate matching obtained under current law, so as to raise revenues, will distort income.

We believe that expenses incurred to remediate—I am sorry I am going over, sir—to remediate an asset to usable condition are deductible under the present law, including expenses to remediate soil and groundwater.

Three months ago, Assistant Treasury Secretary for Tax Policy, Leslie B. Samuels, spoke before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee about allowing wine producers to deduct the cost of replacing vines and/or vineyards that had been destroyed by parasitic infection. He said:

"From a tax policy perspective, it appears appropriate to permit current deductions for costs incurred to replace a grove, orchard or vineyard back into the state it was prior to destruction. In the case of a vineyard, for example, these deductions include the cost of removal of infested plants, removal and disposal of old assets, land preparation, and the planting of new plants." The testimony was on June 22, 1993.

The situation is the same with environmental remediation, where the property is returning to usable condition. However, we are concerned this understanding, one embraced by the administration and the code, regulations and case law has been lost on the Internal Revenue Service who, in two technical advice memoranda, have required capitalization of the costs of removing asbestos and PCBs. We believe these two technical advice memoranda incorrectly require capitalization of certain environmental costs.

If the tax clarification is necessary, it would be to confirm deductibility of remediation expenditures not as a guise for changing the law for the sake of raising revenue.

Regarding compensatory damages under environmental laws, the proposal to deny deduction for payments of compensatory damages relating to actual or potential violations of specific environmental laws, including H.R. 2441, are ill-advised and should be rejected. Under the present law, any fine or similar penalties paid to a government for the violation of any law is not an allowable deduction for tax purposes. However, compensatory or remedial payments are allowed as deductions in determining taxable income. This is as it should be.

Whereas it would frustrate public policy to permit a business deduction for penalties imposed to punish the payor, the exact opposite is true when it comes to payments that are compensatory. Thus, denying a deduction for a payment in the nature of compensatory damages would frustrate the public interest in having claims swiftly and justly settled and the alleged damages corrected.

Compensatory expenses are a legitimate cost of doing business and often represent the most efficient way to resolve conflicts without resort to lengthy and expensive litigation.

The primary reason for opposing proposals that would deny a deduction for compensatory damages is that they seek to use the tax law to punish actions that the substantive law does not consider worthy of punishment. This is not a legitimate use of the Tax Code.

In conclusion, enacting the proposed changes to the tax treatment of remediation expenses and compensatory damages would be contrary to good tax, environmental and economic policy interest. These proposals would retard efforts to clean up the environment, would inaccurately measure income and would impose serious, even damaging costs on U.S. businesses in an increasing competitive global economy. These proposals have nothing to recommend them and should, accordingly, be rejected.

We believe Treasury should review IRS policy and issue guidance. That is within their purview, to clarify deductibility, not only to address asbestos and PCBs but also residual byproducts from historical manufactured gas plant sites.

We would be pleased to work with the administration and the members of this committee to confirm current law, not to change it. We believe it is bad economical, environmental and tax policy to use a clarification in this area as a revenue raiser.

Thank you for allowing me to testify before this subcommittee.

Chairman RANGEL. Thank you, Mr. Gentile.

[The prepared statement follows:]

STATEMENT
on
PROPOSED CLARIFICATION
of the
TREATMENT OF ENVIRONMENTAL REMEDIATION COSTS THROUGH REQUIRED CAPITALIZATION OR UNIFORM AMORTIZATION PERIOD
and
DENIAL OF DEDUCTION FOR COMPENSATORY DAMAGES
before the
SUBCOMMITTEE OF SELECT REVENUE MEASURES
OF THE
HOUSE COMMITTEE ON WAYS AND MEANS
on behalf of
COALITION TO ELIMINATE TAX BARRIERS TO ENVIRONMENTAL CLEANUP
by
Fred J. Gentile
Sr. Vice President of
The Brooklyn Union Gas Company

September 23, 1993

Summary

Adopting the proposed changes in the tax treatment of environmental remediation expenses both to deny deductibility of remediation expenses and compensatory damages would be a serious mistake on a variety of grounds. First, such a change would harm environmental policy goals by making cleanup more expensive. Second, the change would harm tax policy goals relating to the accurate reflection of income and value. Finally, the change would harm the ability of U.S. firms to compete in the global marketplace.

Introduction

Mr. Chairman and members of the Committee, my name is Fred J. Gentile. I am Senior Vice President of The Brooklyn Union Gas Company, a gas utility regulated by the New York State Public Services Commission. We provide gas sales and service to 1.1 million customers, almost all of which are residential, in the New York City boroughs of Brooklyn, Queens and Staten Island. I am pleased to address you today on the matter of whether the tax law treatment of environmental remediation costs should be changed or clarified as a revenue raising measure and on the proposed denial of a tax deduction for amounts paid as compensatory damages in environmental matters. For the record, I am representing today an *ad hoc* coalition of companies that share my own company's concern that tax barriers to environmental cleanup be eliminated. In addition to The Brooklyn Union Gas Company, the coalition includes Ameritech Corp., Georgia Pacific, Commonwealth Edison Co., Greyhound, Inc., Joslyn Corp., North American Coal Corp., Occidental Petroleum Corp., Public Service Company of Colorado, Texaco Inc., WMX Technologies, Inc. The members of this coalition comprise a multi-industry group including representatives from such industries as manufacturing, consumer products, regulated utilities, timber, transportation, pulp and paper, mining, pipelines and environmental services. It is a fact that virtually every business in this country will incur costs of environmental cleanup in order to rectify the effects of past practices. Therefore, we are vitally concerned about the matter before this Subcommittee.

We are testifying today because we believe it would be a serious mistake with no conceivable justification to impose arbitrary capitalization and amortization rules that change the present tax-law treatment of environmental remediation costs to raise revenues. From the standpoint of environmental and business policy, it makes no sense to penalize and thereby discourage -- through the imposition of higher taxes -- desirable cleanup activities. If anything, these activities should be encouraged. Nor would it be good tax policy to seek to raise revenues from "taxing" environmental cleanup activities. Environmental remediation is a complicated process and many factors must be considered when developing an appropriate cleanup plan, selecting from a wide range of possible remedies. This process should not be further complicated through the blunt mechanism of the tax law. The institution of arbitrary capitalization and amortization rules would inevitably have the effect of raising the relative costs of some cleanup methods over the costs of others without serving any coherent tax policy other than to satisfy the quest for more revenue.

Tax simplification and clarification are worthy goals when pursued for their own sake, but they should not be pursued as a means of raising revenue. These two proposals under consideration by the Subcommittee would change the current law in a way that would distort income, penalize environmental remediation activities and thereby reduce or delay those remediation activities. Thus, we oppose these proposals to raise revenue by changing the treatment of environmental remediation expenditures and payments of compensatory damanges in environmental matters.

Present Law Treatment of the Costs of Environmental Remediation

The concept of "environmental remediation" encompasses a wide range of possible activities and expenditures. Most commonly it refers to the treatment and/or removal of soil or water that have become contaminated either abruptly or over a period of time as a result of the discharge of substances now considered to be toxic or through the seepage of substances into the soil or ground water from sites or containers that were damaged by accident or were subsequently determined to be inadequately designed to control those substances. "Environmental remediation" also refers to the encapsulation or replacement of materials -- such as asbestos used for insulation purposes -- that were once considered safe but have now been identified as posing an unacceptable level of risk to people and the environment.

The alternative means for remediation are many and varied, and include treatment with chemicals or biological agents, controlled burning, removal and disposal, and isolation and monitoring. Many of these processes would not be particularly challenging or expensive but for the presence of toxic substances and the need to take extraordinary precautions against further damage to persons or the environment. Other remediation processes are indeed very expensive because they are technically advanced or because they are very time consuming -- sometimes years are required to accomplish the desired degree of remediation.

The one thing each of these remediation activities has in common, besides the tremendous expense that is often involved, is that none of them receives any preferred tax treatment under the current tax law. Some of these expenditures are deductible as ordinary and necessary business expenses while others must be capitalized and amortized or depreciated under general principles of the tax law. However, there are no special tax credits, no special deduction provisions and no "bonus" allowances that are granted as incentives for undertaking these expenditures because they have the effect of cleaning up the environment.

On the contrary, an expenditure for environmental remediation is treated the same as virtually any other business related expenditure made with respect to other property. That is, the expenditure is classified as either a deductible ordinary and necessary business expense or as a capitalizable expenditure in accordance with standards already contained in the Internal Revenue Code, Treasury regulations and in case law.[1] These standards generally look to whether the expenditure: a) increases the value of the property as compared to its value at some previous time; b) increases the productivity of the property, or c) significantly extends the useful life of the property beyond its originally expected life. Granted, it is not always easy to apply these tests in a given circumstance; however, taxpayers are familiar with the tests and apply them every year in many circumstances. There is nothing unique about environmental remediation costs that makes it more or less difficult to apply these same tests to those costs than to literally hundreds of other situations involving other property-related costs.

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[1] (See Internal Revenue Code Sections 162 and 263; Reg. Sec. 1.162-4 and 1.263(a)-1; Illinois Merchants Trust Co. v. Commissioner, 4 BTA 103 (1926) acq. V-2 C.B. 2; American Bemberg Corp. v. Commissioner, 10 T.C. 361 (1948), aff'd per curiam 177 F.2d 200 (6th Cir., 1949), Plainfield-Union Water Co. v. Commissioner 39 T.C. 333 (1962), nonacq. 1964-2 C.B. 8.)

We believe that expenses incurred to restore an asset to its original condition are deductible under the present law, including expenses to remediate soil and groundwater. Three months ago, Assistant Treasury Secretary for Tax Policy Leslie B. Samuels spoke before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee about allowing wine producers to deduct the cost of replacing vines that had been destroyed by a parasitic infestation. He said,

> From a tax policy perspective, it appears appropriate to permit current tax deductions for costs incurred to place a grove, orchard or vineyard back into the state it was prior to destruction. In the case of a vineyard, for example, these deductions include the costs of removal of infested plants, removal and disposal of old assets, land preparation and the planting of new plants. (Testimony of June 22, 1993)

The situation is the same with environmental remediation, where the property is returned to its original, uncontaminated condition. However, we are concerned that this understanding, one embraced by the Administration and the Code, regulations, and case law, has been lost on the Internal Revenue Service, who in two technical advice memoranda have required capitalization of the costs of removing asbestos and PCBs. These memoranda are in clear conflict with the apposite authority. If tax clarification is necessary, it should be to confirm the deductibility of remediation expenditures, and should not be undertaken in the guise of changing the law for the sake of raising revenue. We would be very pleased to work with the Administration and the members of this Committee in this endeavor -- namely to confirm current law, not to change it.

What Is Being Proposed?

The question must then be asked: what is the proposed clarification of the treatment of environmental remediation that would raise revenues? As we have stated, environmental remediation costs receive no preferred treatment under current law and do not represent a particularly unique type of expenditure. Therefore, any such "clarification" could raise revenue only if it were to impose a penalty, relative to current law, on those that incur these expenses. This penalty would be in the form of a higher cost of doing business for those that incur costs to clean up the environment. Revenue would only be raised by a proposal that requires the capitalization of expenditures that are deductible under current law --i.e., those that do not add value, increase productivity or extend the useful life of other property -- or by a proposal that requires expenditures to be amortized over a longer period than the statutory recovery periods that would otherwise apply under current law. Thus, in essence, the proposal would be to impose a tax on the act of cleaning up the environment.

So far as we are aware, no details or justification for such a proposal has been suggested, let alone proposed in a formal manner. That is not surprising. The very thought of imposing a tax on environmental cleanup activities seems so counterproductive to the more important policy of encouraging environmental cleanup, that it is hard for us to imagine a policy justification that might be offered in support of such a proposal. For example, this proposal cannot be justified on the basis of reducing or eliminating a costly tax break or incentive, as is often the reason given for revenue-raising proposals. As we have mentioned earlier, environmental remediation costs cannot possibly be considered a tax-favored expenditure. Rather, we are aware only of the unsupported notion that here is an area where more revenue might be raised.

There are, however, strong policy reasons not to look to environmental remediation expenditures for raising revenues. These include sound environmental and tax policy reasons as well as economic policy reasons.

Policy Considerations

Environmental policy

The most obvious policy reason for not increasing the costs of environmental remediation is the goal that underlies the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) and other environmental protection laws, namely to promote a cleaner, environment. While CERCLA requires cleanup of compromised sites by the responsible party (or its successor), CERCLA is not self-executing. It is necessary for the government to identify the responsible parties and to successfully pursue a civil claim against them. A tax proposal that requires more remediation costs to be capitalized would hinder government efforts to secure clean commercial and industrial sites. This is due to simple economics. The resulting higher costs of environmental cleanup would discourage some responsible parties from coming forward to begin remediation in advance of government action. At the very least, it would cause them to want to delay cleanup efforts or to seek less costly, perhaps less effective, means of remediation. Thus, such a proposal would lead to the cleanup of fewer sites within a given period of time. Clearly, public policy is better served by a tax treatment that does not increase the cost of remediation, but rather reduces the incentive for protracted litigation and mitigates the negative externality and dead-weight loss to society that pollution brings.

Tax policy

From a tax policy standpoint, an arbitrary capitalization rule or a uniform amortization period for all designated cleanup costs is also undesirable. Such treatment would not improve on the accurate measurement of income for tax purposes relative to current law. Current law recognizes the difference between remediation costs that add value to existing property or increase its productivity or extend its useful life, and those that do not. This treatment tends to match the expenditures that provide an ascertainable future benefit with the income that is likely to flow from that benefit. Moreover, it tends to do so over the period that the affected property will be in service. On the contrary, arbitrary capitalization and amortization rules -- designed specifically to depart from the more accurate matching obtained under current law so as to raise revenue -- would distort income.

Even if the proposal is viewed as penalizing polluters and not as penalizing the cleanup activities themselves, proper tax policy requires that the proposal be rejected. The environmental laws and regulations of this country are voluminous, containing many requirements and sanctions, both criminal and civil, for violations. Persons designated to enforce those laws are best suited to making the necessary distinctions between actions that merit penalty and those that do not. In contrast, the tax system is not at all well-suited as a vehicle for delivering a penalty for polluters. A tax law that penalizes expenditures for environmental cleanup through mandatory capitalization makes no distinction between the innocent and the culpable. The tax system is too indiscriminate to be used as an enforcement tool for non tax-related matters.

Economic Policy

Any proposal that further burdens the environmental cleanup process merely adds to the already high costs U.S. firms must pay to improve the environment. Such additional costs would have a far-reaching impact on the ability of U.S. firms to compete effectively in the global marketplace. The competitiveness of U.S. businesses has already been severely strained as a result of the staggering costs that will be incurred by business under our environmental laws. It is counterproductive to further increase that cost, thereby reducing the funds available for these remediation activities. At a time when enviornmental cleanup already is imposing significant costs on U.S. firms, enacting a a tax on those activities would reduce already scarce reinvestment dollars and would be a self-defeating policy.

In summary, there are many reasons to eliminate tax barriers to environmental cleanup, but there are no reasons to erect new ones. This Committee should reject proposals to raise revenue by "clarifying" the law to require that certain environmental cleanup costs deductible under current law be capitalized or by extending the amortization period for capitalizable costs. These proposals would impose an unjustifiable and counterproductive tax on environmental remediation and would hinder the pace of progress in achieving a cleaner environment.

Compensatory Damages Under Environmental Laws

Proposals to deny a deduction for payments of compensatory damages relating to actual or potential violations of specified environmental laws, including H.R. 2441, are ill-advised, and should be rejected. Under present law, any fine or similar penalty paid to a government for the violation of any law is not an allowable deduction for tax purposes. This would include an amount paid as a civil penalty imposed by a federal, state or local law as well an amount paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal). (See Treas. Reg. 1.162-21(b).) The disallowance applies to penalties that are intended to sanction or punish conduct which some well-defined public policy seeks to proscribe. (*True v. U.S.* 90-1 USTC ¶50,062 (CA 10, 1990).) However, compensatory or remedial payments are allowed as deductions in determining taxable income. This is as it should be. Whereas it would frustrate public policy to permit a business deduction for penalties imposed to punish the payor, the exact opposite is true when it comes to payments that are compensatory. Thus, denying a deduction for a payment in the nature of compensatory damages would frustrate the public's interest in having claims swiftly and justly settled and the alleged damage corrected. Compensatory expenses are a legitimate cost of doing business and often represent the most efficient way to resolve conflicts without resort to lengthy and expensive litigation.

The primary reason we oppose proposals that would deny a deduction for compensatory damages is that they seek to use the tax law to punish actions that the substantive law does not consider worthy of punishment. This is not a legitimate use of the tax code. The purpose of the tax laws is to raise revenue for the legitimate needs of the government. The tax laws should not be used as a mechanism by which select behaviors or business practices, unrelated to the tax collection process, are singled out and penalized. This is especially true when the particular behavior that is being singled out -- in this instance, resolving disputes about who should be responsible for environmental remediation -- is a desirable one from a public policy standpoint. Indeed, settlements of disputes about who is responsible for alleged damage to the environment should be encouraged. And those who agree to resolve the matter and to share the responsibility, even though there may be legitimate legal grounds to resist such responsibility or to dispute the means of remediation, should not be discouraged from reaching such a resolution by a tax rule that, in effect, treats the resolution as if it were an admission of culpability.

Moreover, the tax law is ill-suited as a mechanism for determining the proper penalty and imposing it even if one is merited. If punishment is merited, why is the marginal rate of tax on the compensatory payment a relevant measure of the appropriate penalty? If there has indeed been some violation of the environmental laws that merits a penalty, there are ample sanctions that can be imposed within the framework of existing law that measures the particular harm and takes into account all circumstances, not just the fact of an agreement to correct an alleged harm.

Conclusion

Enacting the proposed changes to the tax treatment of remediation expenses and compensatory damages would be contrary to good tax, environmental, and economic policy interests. The proposals penalize environmental cleanup activities in the name of a "clarification" whose sole purpose is to raise revenue. These proposals would retard efforts to clean up the environment, would inaccurately measure income, and would impose serious, even damaging costs on U.S. businesses in an increasingly competitive global economy. These proposals have nothing to recommend them and should accordingly be rejected.

Chairman RANGEL. As you notice, we have been joined by Mr. McCrery, as well as Mr. Kopetski.

All of you are saying you support existing law? There is no one here opposing existing law?

Mr. GENTILE. That is correct.

Chairman RANGEL. And even though you have some disputes with the IRS interpreting existing law, you feel sure you would prevail in court under existing law?

Mr. GENTILE. Correct.

Mr. ROBINSON. Right.

Chairman RANGEL. So if we say we are from the Government, we are here to help you, and to avoid any further problems, to clarify the law and to limit your exposure to further court cases, you would say you don't need any help and existing law is good enough protection for you?

Mr. HOCK. No.

Chairman RANGEL. You want clarification?

Mr. HOCK. We want clarification that the existing law is what we think it is and not what the IRS is tending to say it is.

Chairman RANGEL. You would agree that there are some cases where, while you are trying to clean the environment, that you actually are involved in a capital expenditure and it should not be currently deducted? Under existing law that can be done?

Mr. HOCK. There are cases where certainly there has to be interpretation of the actual situation.

Chairman RANGEL. Yes, I know.

Mr. HOCK. There is a gray area.

Chairman RANGEL. You, being a fair-minded American, you would say you could find cases that you believe it should be capitalized rather than deducted?

Mr. GENTILE. The rules are there to determine whether it is useful, extends the property's life or productivity involved. The current rules allow that interpretation.

Mr. SOLOMON. I think, Mr. Chairman, if you have 67 years of court cases, you can find one or two that are going out there that might muddle the water. The great overwhelming bulk——

Chairman RANGEL. We would not change the law for one or two cases.

If you feel secure that you are protected under existing law, and that when you are just doing these things because it is the right thing to do and you want to protect your employees and the citizens of America, and there is no limit to whether or not just as a side effect the property is substantially and dramatically increased in value, that is just one of the things we have to accept.

You are doing the right thing, and if you put a couple billion dollars in it in doing it, and get a new plant to get rid of an environmental thing, then we should look at it strictly from the health point of view and the good citizenship and just discount whether or not while you are doing the right thing that you have increased the value of your property; or we will leave it to IRS, rather?

Mr. GENTILE. That is a fact. In our case, we have an old manufacturing site that is appraised as the market value, say $1.3 million. But we are incurring to date, site investigation and evaluation, of over $3 million. And that property is not worth any more than the ordinary necessary expenses to get that site in usable condition. So there is no benefit to added value, and the tax law——

Chairman RANGEL. That is your plant.

Mr. GENTILE. My site.

Chairman RANGEL. You are from Brooklyn, so you would normally do the right thing in Brooklyn, especially when you employ our constituents. But if you came from some other community and you looked at the plant, you think the appraised value would just be too high and ridiculous because you are just doing what you had to do?

Mr. GENTILE. In most cases, it is just vacant land, old plant sites that had been manufacturing plants with coal back at the turn of the century, and there are still existing in that particular site the residual byproducts.

Chairman RANGEL. Did I miss in the testimony—everyone wants to help the committee to do the right thing and to be fair and to certainly not have you to change decisions that have already been made as relates to existing law, and I don't think there is enough money involved for us to take that political hit, even though those things have to be weighed—fairness and the revenues.

But I don't think we are going to take that route again. There is not that much money involved and we don't want to discourage people from doing the right thing and penalize them for having already made the decision.

Having said that, were there guidelines that I missed in your statements as to what you think we should do as relates to making the determination?

Mr. GENTILE. Yes, under current law, Mr. Chairman, the revenues will be there for the Government if it is capitalized. If there is an improvement.

So there are cases when there is a depreciation, amortization period, for any major improvement under the current law. So there are cases when it is an ordinary, necessary business expense to make other expenditures. So the current law does give the Government its due revenues from code and case law.

Chairman RANGEL. So we don't have to change that?

Mr. GENTILE. We do not have to change that. There is enough protection for the Government to prevent——

Chairman RANGEL. To prevent abuse or to prevent creative accounting.

Mr. GENTILE. That is correct, proper accounting, Financial Standards Accounting Board allows for that determination also.

Mr. SOLOMON. I think we were concerned that you would clarify it, as might have been suggested in the joint committee report, that you would clarify it that these types of expenses are capital and not expense. And then, if that were the case, there would be a significant change in the law, and I think certainly we did not want that to happen.

Chairman RANGEL. But you were saying you were concerned with retroactivity and seemed more receptive to where we would go in the future in terms of clarification.

Mr. SOLOMON. That is right, but, obviously, if you would clarify——

Chairman RANGEL. Are your clients as big as the other people at the table? Who are your clients?

Mr. SOLOMON. We represent a lot of Fortune 500 companies.

Chairman RANGEL. All of you, really——

Mr. GENTILE. Basically, yes, that is correct.

Mr. HOCK. We are not Fortune 500. We are way down there.

Chairman RANGEL. Well, I don't think that we will be moving with any speed on this matter. It is a thorn in the side of a lot of people. Some want to do the right thing by the environment and, of course, we have to have an existing basis of law as to what is increasing value and whether or not the tax law is being avoided by doing the right thing on the one hand and writing off a heck of a lot that has nothing to do with that on the other hand.

If you are satisfied that existing law does it, we will just have to review and study that again. And none of you are concerned about your liability in court under existing law, you think you can hold your own under that?

Mr. SOLOMON. I think that is true. But the one point that would be helpful in terms of clarification, you just raised this in response over here, is what happens if a tree falls on my plant and damages my plant and I go out and fix it? The plant is going to be a lot more valuable after I fixed it up than it was immediately after the tree fell on it.

Chairman RANGEL. Don't they handle replacement value and all that? Isn't that taken care of under the law, for your tree and your house? That is not a problem.

Mr. SOLOMON. That is exactly the way we read the law, Mr. Chairman. But the Service said that they might want to look at the value of the plant after the tree fell on it and compare that value to what it is after you fix it up. And that certainly does not seem to be a fair comparison in that case. And as we have said, it is inconsistent with all the law that is out there.

Chairman RANGEL. OK. Mr. McCrery.

We have also been joined by Mr. Thomas.

Questions?

Mr. Kopetski.

Mr. KOPETSKI. Thank you, Mr. Chairman.

Mr. Gentile——

Mr. GENTILE. Gentile.

Mr. KOPETSKI. Gentile. I agree with you in terms of supporting the current status of law for deductibility of remediation costs.

I want to turn your attention to page 5 of your testimony with the compensatory damages, whereupon you say that the purpose of the Tax Code is to raise revenue for the legitimate needs of government.

That is one of the purposes of the law. Another purpose of the law is to get corporations, businesses, to do something that we as policymakers feel that is good for the economy, and that is why we establish all kinds of tax credits, and we just did that renewal of the R&D tax credit, for example; isn't that the case?

Mr. GENTILE. That is true.

Mr. KOPETSKI. So it is not just to raise revenue. We also spend money through the Tax Code, if you will, or not bring in as much money, to get businesses to do something they may not do as strongly as we want them to do or not do them at all—tax credits for low-income housing, et cetera.

Mr. GENTILE. That is correct.

Mr. KOPETSKI. Under the current Tax Code, I wonder if the incentives actually are not there to do the cleanup or remediation, when we talk about compensatory damages, because what is going on here is litigation of some sort, whether it is through an administrative agency or a State or local government. It would seem to me that the incentive is not to clean up until the dispute is resolved, because what we are talking about is some sort of judicial determination that, yes, you have to clean up.

And I think in almost all cases accompanying that is some sort of fine or penalty. We say the fines and penalties are not deducted, and the issue before us is whether the compensatory damages should be allowed as a deduction. Well, all you have to do is stall it out and maybe you will pay a fine, you will challenge the amount of the fine, but the incentive is not there to do the remediation.

So if you take away that deduction, then the incentive, therefore, is to do the remediation; is to settle, and maybe even avoid the fine or penalty. So you move that incentive forward.

Mr. GENTILE. On this issue, I think it was the administration's, Treasury's official, who testified on this that he believes it is a current and ordinary deduction, compensatory damages payments. It was before this committee; that it is a legitimate ordinary, necessary business deduction.

Mr. KOPETSKI. Under current law. We are talking about changing the law. They don't get to do that, we do.

Mr. GENTILE. But if that encourages—it would actually make more litigation; more costly. I think it has an opposite effect, I think. Because you look at the economics of your decision as a businessman: Do you want to settle and pay your compensatory payments to resolve this issue and still be a good citizen to clean up what you have to do under the environmental laws?

Mr. KOPETSKI. What I am challenging is that logic itself. If you take away the deductibility, the incentive is to do the cleanup, the remediation, beforehand, because now you can write it off.

Mr. GENTILE. That is true, but it is the least cost to protect the environment. At the same time, you would still be obligated under the environmental laws. There are penalties there you have to pay if you do not abide by the environmental laws; this is the expense incurred to do that.

Mr. KOPETSKI. That is right, and currently, if you do it on your own, you get to deduct it.

Mr. GENTILE. Correct.

Mr. KOPETSKI. And currently, if you are told to do it, currently you get to deduct it. So where is the incentive?

Mr. GENTILE. Well, it is necessary to make these payments to resolve this issue. So it is a legitimate, ordinary business deduction. It is a cost of doing business. It is not improving anything, it is not adding value, it is not adding productivity, it is not doing it for a different reason, the property, so it is a legitimate expense, these payments.

Mr. KOPETSKI. But if you take away the deduction then there is a significant degree of economic incentive to do the remediation before a judicial determination.

Mr. ROBINSON. Mr. Kopetski——

Mr. KOPETSKI. I think he is going to figure out another answer.

Mr. GENTILE. As my attorney is telling me, you have to resolve the problem and find out what has to be done and then you evaluate what are the costs of remediation and then you go ahead and make that determination. You don't make the payments until you see what is the cost to clean up the particular environmental issue.

Mr. KOPETSKI. In these cases, it is not what has to be done, it is whether you have to do it, and that is why there is a contested case.

Mr. GENTILE. Correct.

Mr. KOPETSKI. The company is saying, no, we don't have to do this.

Mr. GENTILE. They are interpreting the law. They look at the requirements. Are they obligated to do and spend a full amount of, exorbitant amount of the cost. And they work with the environmental agencies to resolve this issue.

Mr. KOPETSKI. They are fighting not to do it; right?

Mr. GENTILE. Right.

Mr. KOPETSKI. So I am saying if we do away with that deduction, there will be even more incentive for them to do it.

Mr. ROBINSON. I was just going to say, many times a lot of environmental sites, under the environmental laws, there are a number of different parties who are identified as being potentially responsible. And any businessperson, any corporate officer, has a fiduciary duty to look at and determine whether the costs that are being imposed on their company are reasonable and do they represent their fair share of the cost of cleaning up.

There is also another issue, and that involves if, in fact, you believe you have coverage under liability insurance, you may basically have to be compelled to clean up. If you voluntarily do it, you may be surrendering a claim against your insurance carriers for property damage coverage.

But in the meantime, the fines and penalties are provided under the environmental laws. If you are at fault, if you have done something negligently or willfully, you can be fined and the fines are nondeductible.

Compensatory damages—for the most part, what is really happening is the environmental agency probably has gone ahead and begun cleaning up and you are effectively, through compensatory damages, reimbursing them for not only their cost of cleanup but for the oversight charges that they are charging you for overseeing the cleanup of the site. They are effectively just calling it "compensatory damages," the cost of cleaning up.

Mr. KOPETSKI. And that is what it is. And that is the entire issue.

Mr. ROBINSON. But companies have a legitimate need——

Mr. KOPETSKI. If you do it yourself voluntarily, you get to deduct it and that is in the Tax Code policy and that is well and good. If you take away the deductibility, that puts more pressure and incentive on businesses in this country to enter into settlement agreements before this whole thing is litigated; isn't that the case?

Mr. GENTILE. I don't think it is the case.

Mr. KOPETSKI. I am asking this gentlemen, and that is a yes or no question. Isn't there more incentive?

Mr. ROBINSON. You are right, it would accelerate things. The problem is it is causing you to accelerate a decision that is not a reasonable decision. The decision really needs to be one of how do we fairly measure what our share of the responsibility at a site is when the cost of cleaning up the site is being imposed on a no-fault basis.

Mr. KOPETSKI. Thank you, Mr. Chairman.

Chairman RANGEL. Well, I assume you are working very closely with the environmental groups to hold on to existing law, but you do know there are some loopholes in it and we hope that if we try to clarify the decisions and interpretations, that you will work with us on that so that we won't make your life more difficult. But I just—I cannot—these IRS opinions, none of those are being challenged in court that went against the industry?

Mr. GENTILE. Not yet.

Mr. SOLOMON. It takes time, but, yes, they are being challenged.

Chairman RANGEL. So you are talking still about some liability in terms of having to challenge the courts.

If there is a difference in an existing law, in its interpretation, and you have all of these decisions, I would think that somebody would want a clarification. I mean, I know which way you would want it cleared up, but still, there has to be some line drawn where we could do it and keep the cases out of court, save taxpayers' money, allow you to make long-range decisions and get rid of the rip-off artists that give well-intended firms a bad image?

Mr. GENTILE. Yes.

Chairman RANGEL. Brooklyn excluded?

Mr. GENTILE. Brooklyn excluded.

Chairman RANGEL. Thank you very much.

The next panel will be the California Association of Winegrape Growers, Robert Hartzell, president; the Western Growers Association and Western Pistachio Association, Joseph C. MacIlvaine, the chairman of research, California Pistachio Commission and president of the Paramount Farming Co. in Bakersfield, Calif.; and the California Carrot Board, John Guerard, agronomist, William Bolthouse Farms, Inc., from Bakersfield.

The Chair will now yield to my friend, the distinguished gentleman and protector of pistachios, whatever country we are in, Mr. Thomas.

Mr. THOMAS. Thank you, Mr. Chairman.

Briefly, two of the gentlemen in front of you, Joe MacIlvaine and John Guerard, are constituents of mine. Bob Hartzell has been a long-time associate.

What you are looking at is a significant segment of the specialty agriculture of California, which has been a very bright spot in our balance of trade payments for a number of years. Not only that, the testimony, especially the testimony from Mr. John Guerard with regard to what is going to happen to carrots, will show that whether or not we impose an excise tax on methyl bromide, will have a significant impact on the domestic market.

I would invite the chairman to recall the role that we played in the Superfund in which there was some zealous folk who wanted to classify a number of items as having to share the cost of cleaning up the Superfund. And after we went through a careful scientific examination of products, such as boron and others, our role as the taxing committee actually played a significant role in making sure that evidence that had not been presented elsewhere was presented to the extent we decided not to impose taxes on certain chemicals.

The analogy is not 100 percent here, but it is an important precedent. And having served on the Select Revenue Committee with the chairman in the past, I know that we have a concern that we get all of the facts on the table before we make a decision. And what you will hear from these gentlemen, I think, is a very well argued position that if, in fact, this excise tax goes forward, there are not only dire economic consequences, but there probably are virtually no significant benefits for those who wish to place methyl bromide on the excise tax list as an ozone-depleting chemical.

They will give you more specifics. But one of the things that is occurring now, pleasing to me, is an adjustment back from the hysteria that we had a number of years ago. Even the EPA has admitted perhaps some of the decisions they had made were not based upon the kind of evidence that they would like to make their decisions on.

This is primarily a money question in terms of economics. I think the economic argument is there, without question. I also believe the scientific argument is there as well.

I thank the gentlemen for coming.

They have some exhibits, which I think graphically portray what the result would be if, in fact, we did go forward with the decision to place an excise tax on methyl bromide, and they can do far better than I. They argue it is a constant fight between civilization and the jungle and that this is one chemical that is currently being used in a very careful way to make sure that the jungle does not encroach into every supermarket in America.

I thank the chairman.

Chairman RANGEL. Well, Mr. Guerard, you should know that I have not seen my colleague in any country or any community, urban or jungle, that he has not gone to the full length, notwithstanding scorn and ridicule, to protect the pistachio industry. So that whatever you are using, I am certain that whatever the scientific basis, you can really count Mr. Thomas to be there for you.

You didn't bring pistachios, along with those carrots?

Mr. MACILVAINE. So happens, we did.

Chairman RANGEL. You did.

We are glad to have you.

How long do you intend to stay this morning?

Mr. THOMAS. Until you have enjoyed as many pistachios as you would like.

I want to stay for the questions for a while, Mr. Chairman. It is a pleasure to be back.

Chairman RANGEL. I figured that. Well, we will start with Mr. Hartzell and dealing with the wine.

Do you have grape growers in your district as well?

Mr. THOMAS. I have a number of winegrape growers in my district. We are a major source of winegrapes. Although I don't represent the Napa, the Sonoma or Mendocino Counties, it is not commonly known that in our area we do grow a lot of winegrapes.

Chairman RANGEL. But this methyl bromide issue being included on the taxable ozone depleting chemicals, you are familiar with that?

Mr. THOMAS. I am very familiar with it, and they are going to give you some graphic economic and scientific reasons why we should not do it.

Chairman RANGEL. So, none of these bills here, you believe, makes any sense as relates to what is before us?

Mr. THOMAS. It is the question of placing an excise tax on methyl bromide that brought me here, along with my constituents willing to help us understand.

Chairman RANGEL. So this should be treated differently from the HCFCs that are on the list for the protocol. I know you have done a lot more work on this.

Mr. THOMAS. I have a concern about a number of chemicals being placed on a list without having sufficient scientific evidence or a full appreciation of the economic impact, but my narrow concern right now is methyl bromide and I will entertain other concerns later.

Chairman RANGEL. Mr. Hartzell.

Mr. KOPETSKI. Mr. Chairman.

Chairman RANGEL. Yes.

Mr. KOPETSKI. Having both probably the best grapes or wine in the world in my district, as well as some of the finest timber in the district as well—I have a very diverse district, as you can see—the methyl bromide issue is very important. And the first question I think which has to be answered is whether it should be listed as an ozone-depleting substance, and it has not been listed.

In fact, there are other Federal agencies, such as the Department of Agriculture, that are challenging whether it should be on the list, and my position is it is premature to tax that until it is actually officially placed on the list.

Chairman RANGEL. Well, notwithstanding scientific data, do the grape growers in New York have the same problem you have in California?

Mr. HARTZELL. Yes, they have some problems with phylloxera. Whether or not they use methyl bromide or not, I am not sure.

STATEMENT OF ROBERT P. HARTZELL, PRESIDENT, CALIFORNIA ASSOCIATION OF WINEGRAPE GROWERS

Mr. HARTZELL. Good morning, Mr. Chairman, Congressman Thomas, members of the committee. I would first like to thank you for allowing us to give testimony. Unfortunately, unlike my colleagues, I did not bring samples of wine this morning.

My name system Robert Hartzell, I am president of the California Association of Winegrape Growers. We represent the State's 4,000 winegrape growers on State, national and international issues. And I am here to express our strong opposition to the proposed inclusion of methyl bromide on the IRS' list of taxable ozone-depleting chemicals.

In the full text of my testimony, I have given your subcommittee the important statistics for the California grape and wine industry. It supplies 90 percent of our Nation's grape production, employs 110,000 Californians, pays over $500 million in direct and indirect taxes, and contributes $9 billion to the economic activity of California.

In fact, in the United States, grapes are the 9th largest crop on the basis of value. When you turn those grapes into wine, it becomes the 7th largest crop in the United States.

Unlike annual crops that require methyl bromide each year for soil or post harvest fumigation, grape growers use methyl bromide as a soil fumigant prior to planting vineyards. Our vineyards average 20 to 30 years productive life, with some vineyards lasting 30 years, others less than 10 years.

Major threats to the longevity of our vineyards are infestations of root-destroying insects, primarily nematodes and phylloxera and the fungus known as oak root fungus. All three of these major problems are currently dealt with by treating with methyl bromide prior to planting.

Nematodes are a major problem for growers of table wine, raisin grapes, and all three types, particularly in Congressman Thomas' district and other parts of the Central Valley, where 80 percent of the grapes grown in California are produced. The common practice is to fumigate the bare ground with methyl bromide after removal of the old vineyard or before planting a vineyard infested with nematodes from the previous crop.

As members of the subcommittee may have read, winegrape vineyards in the north coast counties of California, including the premium wine growing regions of Napa and Sonoma Counties, are currently being invaded by a new strain of phylloxera. Phylloxera is the soil louse that devastated the vineyards of California and Europe in the late 1800s and was finally brought under control through the development of resistant rootstocks. The new strain of phylloxera is a mutant that has broken through the rootstock resistance.

The cost of renovating a north coast vineyard by completely removing the old vines, preparing the soil, fumigating with methyl bromide to kill phylloxera and oak root fungus, the planting of vines, trellising, irrigation system installation is $15,000 to $20,000 per acre. Once replanted, the new vineyard will not begin to yield until the third year and not reach productive capacity until it is 5 to 7 years old. Consequently, the grape supply of Napa and Sonoma Counties will probably decrease by about 70,000 tons to about 180,000 tons by 1997.

The total cost to growers for replanting the acreage on phylloxera-susceptible roots in those two counties alone is estimated to be $2 billion by the end of the decade. The current cost to fumigate a north coast vineyard where the treatment is needed to kill phylloxera and oak root fungus is around $1,200 per acre. Of that amount, $500 is for material and $600 is for tarping.

In the parts of the State where oak root fungus is not a problem, primarily the Central Valley, the cost of fumigation is between $550 and $660 per acre.

It is my understanding that at this time methyl bromide has not been officially listed as an ozone depleter and there is no scientific agreement as to the ozone depletion potential for methyl bromide. However, if the full $3.25 per pound excise tax were imposed, it would increase the fumigation cost per acre by $1,300.

In other words, it would more than double or in some cases triple the cost. A completely unrealistic and destructive amount.

If applied, the proposed tax would be a second excise tax on our winegrape growers, in that in 1990, the Congress imposed a 529 percent increase in the excise tax on wine, which is now being passed back to farmers. I might add that we are currently in harvest, and the price of winegrapes in Congressman Thomas' district is about half of what it was a year ago on some of the primary varieties. It is a very devastating picture price-wise in the lower San Joaquin Valley.

Our industry is well aware of the need to find an alternative to methyl bromide. I would hope the members of this subcommittee would understand that the imposition of an excise tax on this critical production tool will destroy our industry's ability to be competitive, will not raise significant revenue for the national Treasury, penalize our 4,000 grape growers, most of whom are small independent farmers already struggling from the previously imposed excise tax on wine.

Any change in the current policy on methyl bromide must be based on sound science. There are too many unknowns with regard to methyl bromide's impact on the environment and, therefore, much more research is needed. It concerns me that while EPA has not yet listed methyl bromide for phaseout, this subcommittee is preparing to supersede EPA's decisionmaking process and tax methyl bromide as if it were a proven ozone depleter.

We have assisted EPA and USDA in their efforts to find an alternative and we will continue to do so. Members of the subcommittee must understand that taking money from the industry's pocket will, in all likelihood, delay the discovery of an effective alternative.

Thank you, Mr. Chairman.

[The prepared statement follows:]

California Association of Winegrape Growers
225 30th Street, Suite 306, Sacramento, California 95816 - (916) 448-2676 FAX (916) 448-0475

Testimony of
Mr. Robert Hartzell
President, California Association of Winegrape Growers
Presented to
the House Ways and Means Committee
Subcommittee on Select Revenue Measures
September 23, 1993

Introduction

Good morning Mr Chairman. I would like to thank you and the members of the Subcommittee for this opportunity to present testimony today. My name is Robert Hartzell, and I am President of the California Association of Winegrape Growers (CAWG). I am here today to express CAWG's strong opposition to the proposed inclusion of methyl bromide on the IRS' list of taxable ozone depleting chemicals.

Economics of Wine and Winegrape Industry

Before I begin, I would like to take a moment to provide some background information on our industry.

California is responsible for providing 90% of our Nation's grape production from just under 700,000 acres of vineyards. The production of about 425-430,000 of these acres is crushed for wine or grape concentrate. In 1992, there were 3.1 million tons crushed, with a total value slightly over $1 billion.

The wine and grape industries play a tremendous role in California's economy. We provide full-time employment for approximately 110 thousand Californians. We pay over $500 million in direct and indirect taxes. All told, our industry contributes over $9 billion to the economic activity in California.

In 1991, California producers supplied 75.3 percent of the wine consumed in the U.S. Our wineries shipped 375 million gallons of wine to all markets, and 7 percent of this was exported. This 7 percent reflects a 533 percent increase in American wine exports from 1985 to 1992, with a total value of $174.4 million.

Purpose of Methyl Bromide

Unlike annual crops that require methyl bromide each year for either soil or post harvest fumigation, grape growers use methyl bromide as a soil fumigant prior to planting vineyards. Our vineyards average 20 to 30 productive years, with some vineyards lasting 30+ years and others less than 10 years.

Major threats to the longevity of our vineyards are infestations of root destroying insects, primarily nematodes and phylloxera, and the fungus Amillaria (sp), known commonly as oak root fungus. All three of these major problems are currently dealt with by fumigation with Methyl Bromide prior to planting.

Nematodes are a major problem for growers of table, wine and raisin grapes in the great Central Valley of California, where 80% of the state's grapes are produced. The common practice is to fumigate the bare ground with Methyl Bromide after removal of the old vineyard, or before planting a vineyard on ground infested with nematodes from the previous crop.

There are currently some rootstocks that appear to be more tolerant than others to nematodes, but the majority of grapes in the main production areas of the central valley are planted on their own roots and are, therefore, susceptible to nematode infestations. Therefore, fumigation with Methyl Bromide is essential.

As members of this Subcommittee may have read, winegrape vineyards in the North Coast Counties of California, including the premium wine growing regions of Napa and Sonoma Counties, are currently being invaded by a new strain of phylloxera. Phylloxera is the soil louse that devastated the vineyards of California and Europe in the late 1800's and was finally brought under control through the development of resistant rootstocks. The new strain of phylloxera is a mutant that has broken through rootstock resistance.

The cost of renovating a North Coast vineyard by completely removing the old vines, preparing the soil, fumigating with Methyl Bromide to kill phylloxera and oak root fungus, vines, trellising, and installation of an irrigation system is $15,000-$20,000 per acre. Once replanted, the new vineyard will not begin to yield fruit until the third year, and not reach its production capacity until it is 5-7 years old. Consequently, the grape supply from Napa and Sonoma Counties will probably decrease around 70,000 tons to about 180,000 tons by 1997.

The total cost to growers for replanting the acreage planted on phylloxera-susceptible roots in Napa and Sonoma Counties alone is estimated to be $2 billion by the end of the decade.

The current cost to fumigate a North Coast vineyard, where the treatment is needed to kill phylloxera and oak root fungus, is $1,200 per acre. Of that amount, $500 is for material and $600 is for tarping. In the parts of the state where oak root fungus is not a problem, the cost for fumigation is $550-$600 per acre.

It is my understanding that, at this time, Methyl Bromide has not been officially listed as an ozone depletor and that there is no scientific agreement as to the Ozone Depletion Potential (ODP) for Methyl Bromide. If the full $3.25 per pound excise tax were imposed on the 400 pounds per acre of Methyl Bromide used for fumigation prior to planting grapes, it would increase the fumigation cost per acre by $1,300. A completely unrealistic and destructive amount.

Industry Depends on Methyl Bromide

Without the use of methyl bromide, grape production--and this includes raisins, table grapes, and winegrapes--would be significantly diminished. An April 1993 report entitled "The Biologic and Economic Assessment of Methyl Bromide" published by the U.S. Department of Agriculture's National Agricultural Pesticide Impact Assessment Program gave two grim scenarios for our industry should methyl bromide use be prohibited.

Scenario A - Methyl bromide canceled, other fumigants available

1. Twenty percent of the acreage would be allowed to lie fallow for four years in order to allow infestations to diminish. This would mean a 100 percent loss of production of these lands for four years.
2. Seventy percent of the acreage would receive metam-sodium at a cost of $525 per acre.
3. Five percent would be treated with non-fumigant nematicides with variable costs.
4. Five percent of the acres would be planted without treatment and be predisposed to abandon production.

Scenario B - No fumigants available

1. Sixty-five percent of the acreage would be allowed to lie fallow for four years with 100 percent loss of production.
2. Production would be abandoned on thirty percent of the acreage because it is infested with Amillaria sp., and grapes cannot be grown on such land without methyl bromide.
3. Five percent of the acres would be planted without chemical control and would be predisposed to abandoning production.

The report also concluded that "[ultimately],the forty percent first year loss would be compounded each year, eventually resulting in a one hundred percent loss of production."

So you can understand the concern we have for this proposed tax.

The industry has also invested a substantial amount of time and money through our governmental and nongovernmental scientists to develop an alternative to methyl bromide, but to date, we have been unsuccessful.

Wine Industry No Stranger to Excise Tax

The contemplated excise tax on methyl bromide would be a second excise tax on growers. In 1990, Congress increased the excise tax on table wine by 529%. The tax went from 17 cents per gallon to $1.07 per gallon - and the reality is that, substantially, all of this increase has turned out to be paid by grape farmers in the form of reduced grape prices. Let me explain.

During the time Congress was debating the increase, I kept hearing throughout the halls of Congress - "Sin Tax" and $1.07/gallon is only 21 cents/750 milliliter bottle. Surely a consumer who can pay $12 to $15 for a bottle of wine can afford 21 cents.

Here's the reality. The $1.07/gallon is paid to the Department of the Treasury by the winery at the time the wine is removed from bond. Now, the winery can do one of three things to recover that additional cost:

1. It can absorb the additional cost.
2. It can add the additional cost to the bottle of wine.
3. It can reduce the price it pays growers for grapes by the amount of the increase.

Our experience is that the latter is what occurs. First, because a business that tries to absorb those kinds of costs isn't around long (and certainly, there are plenty of wineries in financial trouble). Second, with the recession and extremely competitive retail wine market that is so price sensitive, passing the cost forward is not realistic. Therefore, the federal Excise Tax is passed back to the grape farmer.

NAFTA's Impact

Just last week, your Committee began hearings on the North American Free Trade Agreement (NAFTA) and this trade agreement is important because winegrape concentrate and grape juice is produced in Mexico.

One of the concepts of the NAFTA was to revise the tariff and non-tariff barriers to permit the business person with the comparative advantage to excel. But a methyl bromide excise tax will make it more difficult for us to compete against the Mexican vineyard industry as Mexican producers do not pay any tax on methyl bromide.

U.S. Industry Put at a Competitive Disadvantage

It is estimated that over 90 percent of U.S. table grape imports were fumigated with methyl bromide in 1989/1990. These grapes fill an important niche in U.S. supplies. For example, the United States imports table grapes from Chile when U.S. production is zero or near-zero. In 1989/1990, during the months when table grapes fumigated with methyl bromide arrived in the United States, they represented over 50 percent of total U.S. supplies.

U.S. growers will be unable to compete in the domestic or international market if this tax is imposed.

Conclusion

Our industry is well aware of the need to find an alternative to methyl bromide. I would hope that members of this Subcommittee would understand that the imposition of an excise tax on this critical production tool will destroy our industry's ability to be competitive; will not raise significant revenue for the national treasury; and will penalize our 4,000 grape growers, most off whom are small, independent farmers already struggling from the 529% wine excise tax increase just imposed in 1991.

While we understand the impetus behind the proposed tax, our industry is already working with researchers to try to find an alternative, but that takes time. The proposed tax will only serve to take away from the resources available to allocate to research. Please keep in mind that our grape growers must remain profitable for any of the research and tax income to be realized.

Any change in the current policy on methyl bromide must be based on sound science. There are too many unknowns with regard to methyl bromide's impact on the environment, and therefore, more research is needed. It concerns me that, while EPA has not yet listed methyl bromide for phase-out, this Subcommittee is preparing to supersede EPA's decision making process and tax methyl bromide as if it were a proven ozone-depletor.

We have assisted EPA and USDA in their efforts to find an alternative, and we will continue to do so in the future. Members of the Subcommittee must understand that taking money out of industry's pockets will, in all likelihood, delay the discovery of an effective alternative.

Thank you again, Mr. Chairman, for the opportunity to testify here today.

Chairman **Rangel**. Thank you. Your argument is persuasive. This is not in the Montreal Protocol nor is it listed as a dangerous drug anywhere? It is just——

Mr. **Hartzell**. As I understand, in the Montreal Protocol it is scheduled for phaseout by the year 2000, if I am——

Chairman **Rangel**. What was the scientific basis for that decision?

Mr. **Hartzell**. I am not aware of that. I am not that deep in the subject.

Chairman **Rangel**. But you have to become aware of it?

Mr. **Hartzell**. Yes, but I don't know the scientific basis for the Montreal Protocol.

Chairman **Rangel**. So, therefore, you cannot challenge it?

Mr. **Hartzell**. I can't answer your question, is what I am saying.

Chairman **Rangel**. Do you know whose bill this is, Mr. Thomas?

Mr. **Thomas**. I do not.

Chairman **Rangel**. You don't know who is the advocate of this bill you are challenging; do you?

Mr. **Hartzell**. I understand it was advocated by Congressman Pete Stark.

STATEMENT OF JOSEPH C. MacILVAINE, CHAIRMAN OF RESEARCH, CALIFORNIA PISTACHIO COMMISSION; AND PRESIDENT, PARAMOUNT FARMING CO., BAKERSFIELD, CALIF., ON BEHALF OF THE WESTERN GROWERS ASSOCIATION AND WESTERN PISTACHIO ASSOCIATION

Chairman **Rangel**. Mr. MacIlvaine.

Mr. **MacIlvaine**. Good morning, Mr. Chairman, members of the subcommittee. My name is Joe MacIlvaine and I am appearing today on behalf of the Western Growers Association and Western Pistachio Association.

In my private life, I am the president of Paramount Farming Co. which grows almonds, citrus, olives, pistachios, and other crops in the San Joaquin Valley.

Western Growers Association membership is involved in the production of every type of fruit, vegetable, and nut. The proposed notice that methyl bromide may be listed as a potential ozone depleter came as a real shock to our membership. Today, methyl bromide stands as the only fumigant to combat and control pests on numerous crops, both for preplant soil fumigation and postharvest purposes.

The removal of the fumigant from the market, either through an excise tax or through the Clean Air Act, will strike a devastating blow to many sectors of the agricultural community.

Growers of numerous crops in California and Arizona have been experimenting with possible alternatives to methyl bromide; however, none come close to performing as effectively as methyl bromide and, in fact, for many crops, there are really no alternatives. It is not a case of attempting to hold onto a cheaper fumigant. Study after study has demonstrated yields will be impacted by up to 50 percent.

When we are attempting to make a 10 percent return on our investment, a 50 percent loss in production removes any prospect of remaining in business. I urge the members of this subcommittee to study the publication "The Biologic and Economic Assessment of Methyl Bromide," prepared by the National Agricultural Pesticide Impact Assessment Program, U.S. Department of Agriculture. In fact, I would urge the subcommittee to incorporate this study into today's hearing record. It supports all the growers' contentions that are made that no available alternatives to methyl bromide exist at the present time.

The list of crops requiring the fumigant both for import and export purposes is extensive. For example, a crop grown by my company, pomegranates, cannot be exported to certain countries demanding fumigation. Other crops with a similar dilemma are apricots, broccoli, grapes, grapefruit, lemons, nectarines, peaches, plums, oranges, and walnuts.

Watermelon, cited by the Center for Science for the Public Interest as one of the most nutritious fruits, requires methyl bromide for its production at certain times of the year in California. Without methyl bromide, or with additional costs associated with methyl bromide, the winter watermelon industry could not exist and very likely would move out of the country.

Another consequence of the excise tax is its discriminatory nature. For example, not all soils are infested with nematodes. Consequently, the farmer or rancher that has lands with a nematode infestation will be forced to either stop producing or will pay a very high price for methyl bromide.

In addition, some growers have developed an export market, and the removal of methyl bromide through an excise tax would virtually eliminate that market for those growers.

In many of our commodities, we are working in partnership with the Government to open markets to U.S. products throughout the world. It would be ludicrous to adopt tax barriers within this country which would prevent our products from entering these newly opened markets.

Speaking just briefly on the subject of pistachios, there are in the world today two major producers of pistachios, the United States and Iran, and although Iranian pistachios are currently excluded from the United States market and face duties of approximately 300 percent, we compete directly with Iranian pistachios all around the world, and 30 percent of the U.S. crop is exported. The export market is very important to the industry from an economic point of view.

Pistachios require fumigation for export to certain countries, some of our most important export destinations, and the taxing of methyl bromide would make that export noncompetitive with pistachios from Iran.

I think when the committee's economists review the potential revenue from the tax on methyl bromide, we would recommend several considerations:

Will the production simply move out of the country, to Mexico, for example? Will production decrease because of the added economic burden? Will the export crop simply be moved to another country for fumigation, sort of a second stop in-between? Will the excise tax cause the buyers to import the crop instead of buying domestically grown product?

In conclusion, we urge the members of this subcommittee to reject the methyl bromide excise tax. The Clinton administration has not designated the fumigant as an ozone depleter, and the action by the subcommittee would be premature. Even in the scientific community, there is not consensus on the actual impact of methyl bromide and additional research is necessary. Perhaps this would be one subject that could warrant the subcommittee's members to visit our growing areas in California to gain firsthand experience on the necessity for methyl bromide.

I appreciate your attention.

Some of you may not be fully familiar with pistachios and I have brought a sample here to submit for your edification.

Thank you very much.

[The prepared statement follows:]

Testimony of
Dr. Joe MacIlvaine
on behalf of
Western Growers Association
and
Western Pistachio Association
Presented to
The House Ways and Means Committee
Subcommittee on Select revenue Measures
September 23, 1993

Introduction

Good morning Mr. Chairman, members of the Subcommittee.

My name is Joe MacIlvaine, and I am appearing today on behalf of Western Growers Association and the Western Pistachio Association. I appreciate having the opportunity to share WGA's and WPA's views on the proposed tax on methyl bromide.

I serve on the Board of Directors for the Western Growers Association and serve on the California Pistachio Commission where I am the Chairman of the Research Committee. In my private life, I am the President of Paramount Farming Company which grows almonds, citrus, olives, pistachios and other crops.

Western Growers Association

The Western Growers Association represents over 1,500 growers and shippers of fresh produce in California and Arizona. The members of Western Growers produce approximately 50% of the fresh fruits and vegetables grown in the United States.

Our membership grows in excess of some 200 horticultural products as described in the Harmonized Tariff System. Consequently, my testimony will focus on the fresh fruit and vegetable sector as a whole.

Methyl Bromide in the Fresh Fruit and Vegetable Industries

WGA membership is involved in the production of every type of fruits, vegetables and nuts. The proposed notice that methyl bromide may be listed as a potential ozone depletor came as a real shock to our membership. Today, methyl bromide stands as the only fumigant available to combat and control pests on numerous crops both for preplant soil fumigation and post harvest purposes. The removal of the fumigant from the market, either through an excise tax or through the Clean Air Act, will strike a devastating blow to many sectors of the agricultural community.

Growers of numerous crops in California and Arizona have been experimenting with possible alternatives to methyl bromide; however, none comes close to performing as effectively as methyl bromide. This is not the case of attempting to hold on to a cheaper fumigant. Study after study has demonstrated yields will be impacted by up to 50 percent. When we are attempting to make a 10 percent return on our investment, a 50 percent loss in production removes any prospect of remaining in business.

The removal of methyl bromide because of a tax will result in the following:

- production will decrease;
- retail prices will increase significantly; and
- where possible production will move to another nation such as Mexico where growers do not face a methyl bromide tax.

I urge members of the Subcommittee to study the publication, The Biologic and Economic Assessment of Methyl Bromide, prepared by The National Agricultural Pesticide Impact Assessment Program, U.S. Department of Agriculture. In fact I urge you to incorporate the study into today's hearing record. It supports all the growers' contentions that there are no available alternatives to methyl bromide.

Fresh Fruit and Vegetable Industry Uses of Methyl Bromide

The list of crops requiring the fumigant both for import and export purposes is extensive. For example, a crop grown by Paramount Farming Company, pomegranates, could not be exported to nations demanding fumigation. Other crops with a similar dilemma are apricots, broccoli, grapes, grapefruit, lemons, nectarines, peaches, plums, oranges, pistachios, and walnuts.

Watermelon, cited by the Center for Scientific for the Public Interest as one of the most nutritious fruits, requires methyl bromide. The winter watermelon crop is grown in Kern, Imperial and Riverside Counties in California. This year, there were over 1,500 acres of winter watermelon plantings, and in 1994 the number of acres is expected to increase to 1,800. Historically, this watermelon crop is the first planted and harvested in California each year, and it is a forced planting when the temperature is too cold for open field planting.

Methyl bromide is the vital link that enables the watermelon industry to plant early. To compensate for the low winter temperatures, plastic tarping (plastic mulch) is used to provide the additional heat retention necessary to accelerate maturity. The plastic mulch creates a greenhouse effect which creates ideal growing conditions. Unfortunately, this condition is also perfect for weeds, soil disease, and insects. For this reason, prior to planting, the soil is treated with methyl bromide to provide a sterile environment for the crop.

Without methyl bromide or with any additional costs associated with methyl bromide, the winter watermelon industry could not exist and will move to Mexico.

Western Pistachio Association

The U.S. pistachio industry is relatively young. While pistachios were first planted in California in the 1880s, pistachios were not commercially harvested until the 1970s, and the first significant crop was not produced until 1976. Since that time, the pistachio industry has expanded to include significant orchards in Arizona, Nevada, New Mexico, and Utah. And recently, growers have experimented with orchards in Texas. There are approximately 550 pistachio growers in the U.S. Our industry has grown from almost zero farm gate revenue in 1975 to some $135 million to $155 million in 1992.

The Western Pistachio Association is comprised of members from 16 states and several foreign countries. The Association works to ensure the economic vitality of the entire pistachio industry. Its goal is to keep members informed of political and legislative issues that will impact the pistachio industry while protecting the interests of the industry in Congress and federal agencies.

In the world today, there are only two major producers of pistachios - the United States and Iran. In 1986, the International Trade Administration approved unfair trade action duties of approximately 300 percent ad valorem. While we do not compete against Iran in the U.S. because of the duty and a Presidential embargo, thirty percent of production is exported, and we face Iran in these export markets.

Pistachio Industry's Use of Methyl Bromide

Certain nations require the imported pistachios to receive post harvest fumigation. Methyl bromide is used.

If an excise tax is imposed on the post harvest methyl bromide fumigation, it will be a severe penalty as U.S. exports will no longer be allowed into one of our most profitable markets, and Iran will continue use methyl bromide for their pistachio exports.

Methyl Bromide Tax is an Inequitable Solution

Another consequence of the excise tax is the discriminatory nature of the excise tax. For example, not all soils have nematodes. Consequently, the farmer or rancher that has land with nematode problems will be forced either to stop producing the crop or pay a high price for methyl bromide. In addition, some growers have developed an export market; if he or she cannot use methyl bromide for the post harvest fumigation because of the costs, then the market will be lost to another nation.

As we are working to open markets to U.S. products throughout the world, it would be ludicrous to adopt tax barriers within this country which would prevent our products from entering these newly opened markets.

Tax Will Hurt Consumers Too

Both growers and consumers would be adversely affected by a tax on methyl bromide, as the grower's costs will be passed on to the consumer. Under the proposed excise tax methyl bromide would be taxed on a per pound basis. As we understand this proposal, in 1994, methyl bromide would be taxed at a rate of $3.05 per pound and $3.75 per pound in 1995 and increased 45 cents per pound each year.

By the year 2000, growers will pay $5.32 per pound for methyl bromide. So each year, we can expect growers to pass this added burden on to the consumers. Unfortunately, this will not always be possible. Some industries will be unable to pass the costs along. Eventually, this added burden will force U.S. producers out of these industries.

Prospective Federal Revenue from Excise Tax

When the Committee's economists review the potential revenue from a tax, on methyl bromide, we recommend several considerations:

- will the grower move production to Mexico;
- will production decrease for the crop using methyl bromide;
- will the export crop be moved to another nation for fumigation before it is sent to the nation requiring post harvest fumigation; and
- will the excise tax cause the buyers to import the crop instead of purchasing the domestic crop at a higher price.

Conclusion

We urge the members of the Subcommittee to reject the methyl bromide excise tax. The Clinton Administration has not designated the fumigant as an ozone depletor, and the action by the Subcommittee would be premature. Even in the scientific community there is not consensus on the actual impact methyl bromide has on the environment, and additional research is needed. Perhaps this would be one subject that would warrant the Subcommittee members to visit our growing areas to have a first hand experience on the necessity for methyl bromide.

Furthermore, the hidden tax to the consumer, a potential decrease in crop production and the decrease in exports are goals I am sure this Subcommittee is not advocating. And lastly, Mr. Chairman, we do not believe the excise tax will reach your revenue expectations.

I appreciate your attention. If you have any questions. I will be happy to try to answer them.

Chairman RANGEL. Your doctorate is what discipline?

Mr. MACILVAINE. Actually, it is unrelated to my present testimony. I am a Doctor of Philosophy from MIT and my degree is in oceanography.

Chairman RANGEL. But the ozone depleting problem, you are just saying it is bad business to tax, really, pistachios?

Mr. MACILVAINE. No, it is not just pistachios, and certainly—this tax would have a devastating economic impact on a very broad spectrum of agricultural and forestry products throughout the United States.

Chairman RANGEL. But if, indeed, this chemical was put on a list where scientifically it was proven to be dangerous to the ozone, then you would have had a different argument rather than just the tax?

Mr. MACILVAINE. Certainly my understanding is that the subject on the table today is specifically this tax.

Growers are working, I might even say, frantically, to discover alternatives to the use of methyl bromide. We understand methyl bromide faces challenges from a number of different fronts. But our point today is that we should not add to those burdens with an excise tax.

Chairman RANGEL. Especially when the chemical has not been proven to have that negative impact.

Mr. MACILVAINE. That is correct.

STATEMENT OF JOHN GUERARD, AGRONOMIST, WILLIAM BOLTHOUSE FARMS, INC., BAKERSFIELD, CALIF., REPRESENTING THE CALIFORNIA CARROT BOARD

Chairman RANGEL. Mr. Guerard.

Mr. GUERARD. Mr. Chairman, members of the subcommittee, I am John Guerard, and I am appearing on behalf of the California Fresh Carrot Advisory Board in opposition to the proposed methyl bromide excise tax.

The California carrot industry is quite specialized and grows approximately 56,000 acres in California 12 months of the year, which is 60 percent of the Nation's production, with other significant carrot-producing regions in Florida and Michigan. The total value of the Nation's carrot industry is approximately $320 million.

The growing period for carrots is approximately 24 weeks and they are harvested mechanically. Most of our production is for fresh consumption and for the baby-cut carrots. Consumers eat about 1.4 million tons of carrots each year.

Chairman RANGEL. Mr. Guerard, the value to America and the world about the quality of carrots, I think, has been embedded in us from childhood. I would want you to know I take notice these things go unchallenged.

Mr. GUERARD. Thank you.

So, consumption has increased over the years and we expect that to continue, especially as more and more reports come out about the nutritious and health-related benefits of carrots.

Fresh carrots are available year-round, are inexpensive, they have little waste and are easy to store. They are low in calories and a good source of fiber and, of course, they are high in beta-carotene.

Why is methyl bromide so essential for the growing carrots? It is because carrots are very sensitive to and attacked by plant parasitic nematodes, which are small microscopic worms found in the soil which damage the roots by feeding on them.

Today I brought a few samples of carrots you would normally buy in the store and that you would have available to you. I have also brought—we just harvested a few days ago, carrots that were damaged by nematodes. These are infected with galls from root-knot nematodes, carrots being one of the most sensitive crops to nematodes.

These, by the way, were fumigated with an alternative product—in fact, our only alternative fumigant to methyl bromide—and you can see it is highly ineffective as a comparative material.

[The prepared statement follows:]

California
FRESH CARROT
Advisory Board

Phone: 209/591-5675
Fax: 209/591-5744

531-D North Alta Avenue
Dinuba, California 93618

Testimony of
Mr. John Guerard
of Bolthouse Farms
on behalf of the California Fresh Carrot Advisory Board
before the House Ways and Means Committee
Subcommittee on Select Revenue Measures
September 23, 1993

Introduction

Good morning. I am John Guerard, and I am appearing on behalf of the California Fresh Carrot Board in opposition to the proposed methyl bromide excise tax.

The California Fresh Carrot Board is a quasi-government organization created by state law. Its purpose is to conduct education, market development, research, merchandising, and advertising on behalf of growers in California.

Description of California Carrot Industry

The California carrot industry grows carrots on approximately 56,000 acres twelve months a year, which is 60 percent of the nation's production - with the other significant production regions in Florida and Michigan. The total value of our nation's carrot industry is approximately $320 million per year.

The growing period is approximately 24 weeks, and the carrots are harvested mechanically. Most of our production is for fresh consumption such as whole or baby cut carrots.

The Carrot

Consumers eat some 1.4 million tons of carrots each year, and we expect this to increase as more and more consumers understand the nutritious and health related benefits of carrots. Fresh carrots are available year round, are inexpensive, have no waste, and are easy to store. Low in calories, they are a good source of fiber, potassium, and other minerals and are extremely high in beta-carotene.

Fresh fruits and vegetables are an important part of everyone's diet, but most specifically children's. Of all the fruits and vegetables, carrots are richest in beta-carotene, the precursor of vitamin A. Children lacking sufficient vitamin A are more susceptible to infections. Their bones and teeth may not develop properly, and their growth can be retarded. An extremely severe vitamin A deficiency in young people can cause xerophthalmia and ultimately blindness. Insufficient vitamin A is also known to be the primary cause of blindness in American children. In third world countries the problem is even worse and accounts for an estimated 80,000 cases of childhood blindness each year.

Vitamin A is also very important for adults. Adults who lack adequate vitamin A provided by beta-carotene may suffer from night blindness and are frequently very sensitive to sunlight glare. Their fingernails often split, peel and become ridged; their skin develops blemishes, wrinkles, and becomes dry, while their hair becomes dry brittle and dull.

As you can see for yourselves, our carrots are visibly appealing. However, I have brought with me today fresh examples that have been attacked by nematodes. These carrots are good to eat but we have learned that for obvious reasons consumers do not find these carrots appetizing.

Methyl Bromide Use

The carrot industry has used methyl bromide since Telone was suspended as a pre-plant soil fumigant in California in 1989. Methyl bromide is applied once per growing season at least three days before planting. The proposed dilution rate is 300 pounds per acre. I can assure you at $3.05 per pound, we will not plant carrots because this translates to $1,000 per acre in additional costs. At this rate you will be eating Mexcican carrots. Methyl bromide is only effective as a pre-plant fumigant. No post-planting treatment will effectively control pests.

Despite the importance of methyl bromide to our industry, EPA has only approved methyl bromide for use on just over one-half of our crop. After a tolerance is established, then all the crop can be treated with methyl bromide. Even with this limited approval, we still have problems treating our acreage. In 1992, methyl bromide use was suspended for a period of several months to conduct studies.

The carrot industry has dedicated thousands of dollars researching alternatives. I have in my hand a folder containing the results of several studies the carrot board has funded in the past, and still, we have no effective alternatives to methyl bromide.

In one study completed this year, when methyl bromide was used, the yield of carrots averaged 3.0 tons more than the next best alternative.

Need for an Effective Fumigant

The proposed methyl bromide excise tax is a real threat to our carrot production industry. The proposal will be the first indirect excise tax of food. Yes, the consumer will not see the excise tax labeled on the carrot bag, but clearly the consumer will notice it on the price paid for carrots.

Carrot growers do not have any good alternatives to methyl bromide, and the tax would cause further disruption in our industry. This disruption will create an imbalance between supply and demand and drive the price to the level that low income consumers can not afford. The excise tax will become a regressive tax for our low income consumers.

Why is methyl bromide so essential for the growing of carrots? Carrots are attacked by plant parasitic nematodes which are small, worms, round in cross section, with smooth, unsegmented bodies, without legs or appendages. They are invisible to the naked eye but are easily observed under the microscope. All nematodes have four larval stages and a life cycle may be completed in 3-4 weeks. Soil temperature, moisture, and aeration affect the movement and survival of nematodes. Nematodes move very slowly through the soil. Their movement is faster when the pores are lined with a thin film of water.

Nematodes damage plants by a secretion of saliva injected into the plant. The nematodes puncture the cell wall, inject saliva into the cell, and suck part of the cell contents. The feeding injures the plant which results in dead root tips and buds, lesion formation, swellings, galls, and stinted foliage growth. In addition nematode damaged plants are susceptible to secondary plant diseases. In some cases an association develops between nematodes and pathogen forming a diseased complex.

Carrot crops rely heavily on methyl bromide fumigation. Even if alternative fumigants were used, without methyl bromide, ten percent of the acres would need to be rotated to other crops losing three to five years production. If neither methyl bromide nor an alternative were available, one hundred percent of the treated acres would be placed in rotation, resulting in a drastic cut in production for three to five years.

Conclusion

The carrot industry was hit hard in 1989 when Telone was suspended in California. We switched to methyl bromide which is two to three times more expensive than Telone. If we are hit by this proposed tax, methyl bromide will no longer be economically practical to use. As I stated above, without methyl bromide, the industry could suffer drastic production loss in three to five years.

We do not understand the impetus behind this tax. Last year, 56 million pounds of methyl bromide were used. If methyl bromide is taxed at $3.05 per pound, revenues raised from this tax would only be $170 million dollars per year. In terms of a simple cost-benefit analysis, the costs of this tax, lost jobs, lost production, and higher prices at the checkout line, far outweigh the benefits. If the food industry is prohibited from using methyl bromide, the U.S. Department of Agriculture estimates a $1.4 Billion loss just from crops using fumigation in soil and for importing purposes. This does not include U.S. Exports.

We ask members of the Subcommittee to reconsider this tax, and allow us to use this money for a more important purpose - finding an effective alternative to methyl bromide.

Thank you, Mr. Chairman.

Mr. THOMAS. Want to try one of those, Mr. Chairman?

Chairman RANGEL. Listen, I am impressed with everything, and most of all, before I yield to Mr. Thomas, I just wanted to make it clear that Mr. Thomas has the ability to bring these things in very graphic scientific, and many times, lengthy ways, to the subcommittee.

He has already persuaded me this legislation is premature, and I do hope you know that there are some questions about the impact this chemical has on the environment. And so, therefore, we all should do what we can to find alternatives.

But, meanwhile, if the scientists reach a conclusion, then you know that we probably will treat it the same way we do others. But until it is involved in a protocol, until there is evidence to show the damage, I really don't see why we should report this to the full committee.

And now I yield to Mr. Thomas.

Mr. THOMAS. Thank you, Mr. Chairman.

The graphic nature of the carrot is obvious once you understand that when Mr. Hartzell talked about the roots of the grapevine, and Mr. MacIlvaine talked about the roots of the pistachio and other products, that our friend, the carrot, is, in fact, the root and, therefore, you see the kind of damage that is done very graphically.

Chairman RANGEL. We are moving ahead swiftly on this, I can see.

Mr. THOMAS. And, in conclusion, Mr. Chairman, the root of the problem is that without conclusive scientific evidence, and with the enormous economic impact of the loss of methyl bromide, I appreciate the chairman's understanding that we should not move forward until there is clear—clear—scientific evidence.

The industry is working night and day to find reasonable alternatives, but to move an excise tax now because someone thinks it is a good idea, in fact, validates some of the silly decisions that were made earlier.

Once we have sufficient scientific basis, we then also, in my opinion, still need to weigh the economic damage, if we do not have a substitute for methyl bromide. I think you will find it is far down the list in terms of environmental damage. It is at the top of the list in terms of our ability to compete economically in the agricultural world.

I thank the chairman for his wisdom.

Chairman RANGEL. Well, let me thank the panelists and—off the record.

[Discussion off the record.]

Chairman RANGEL. Thank you very much.

Panel three consists of National Realty Committee, Stefan F. Tucker, counsel; Chicago Title and Trust Company, Wyckliffe Pattishall; John W. Lee, professor of law, College of William & Mary, Howard Levine, managing partner, Roberts & Holland here in Washington.

We do change subjects fast.

Suppose we start with Mr. Tucker.

STATEMENT OF STEFAN F. TUCKER, COUNSEL, TUCKER, FLYER & LEWIS, ON BEHALF OF THE NATIONAL REALTY COMMITTEE

Mr. TUCKER. Good morning. Thank you very much, Mr. Chairman and staff.

I am Stefan Tucker. I am a member of the law firm of Tucker Flyer & Lewis, in Washington, D.C. I am tax counsel to the National Realty Committee.

By way of analogy from real estate to the agricultural products you have just seen, I would point out until the Tax Reform Act of 1986, real estate was considered a 24-karat investment. Unfortunately, that has changed over the past few years.

The National Realty Committee is the real estate roundtable in Washington on national issues affecting real estate. Its members are America's principal commercial and multifamily real estate owners, advisers, builders, investors, lenders, and managers.

The proposal that we are focusing on today is to impose upon the present rules of like-kind exchanges, the similar or related in-service, in-use rule of 1033–A of the Internal Revenue Code applying generally to involuntary conversions.

I would recall the fact that in 1958, the Senate Small Business Committee on behalf of the Nation's small business, introduced an act, that ultimately became a 1958 Tax Act, that brought into the Internal Revenue Code Section, 1033–G of the Internal Revenue Code with regard to involuntary conversions or condemnations of real estate, that said that you would have the same like-kind provisions as to involuntary conversions or condemnations that we now have in other like-kind exchanges under section 1031.

It is interesting to see there is now a proposal to move from the straightforward simplicity of section 1031 for like-kind exchanges, into the difficult and extraordinary situations that result into a lot of litigation under section 1033–A, as to what is or may be similar or related in service or use.

The Treasury Department, we are pleased to note, opposed this particular provision on the basis that the administration is not persuaded that there is presently any need to revise the standard based on the use of property received in exchange of like-kind property for determining whether property exchanges qualify for tax deferral. We agree with the Treasury Department in this context.

The concept of similar or related in service or use is a far narrower provision that focuses on, with respect to an investor, the kind of services that go into the property, and with respect to an owner-user, the kind of use that goes into a property, and has resulted, under section 1033–A, in a number of what we see as extremely strange rulings of the Internal Revenue Service that have, at times, had to have been reversed by the courts in terms of this.

For example, in 1976, in Revenue Ruling 76–319, there was a billiards center that had been reinvested in by a taxpayer, which had a lounge. And they had invested the proceeds from a fire on a bowling center, which likewise had a lounge. And the Internal Revenue Service said that a billiards center and a bowling center simply are not similar or related in service or use.

In 1970, the Internal Revenue Service focused on a hotel that had been destroyed by fire. Revenue Ruling 70–399. The hotel had been subject to a net lease. When it was rebuilt with the proceeds from insurance, they then did the hotel as an owner-operator hotel.

The holding of the Internal Revenue Service was this was not similar or related in service or use because, on the one hand, it had been net leased and, on the other hand, it had been owner-operated.

Now, we all can get around these kinds of things if we want to go through the intricacies of getting around them and result in a lot of audit issues and a lot of litigation and a lot of misuse of the courts for what ought not to be used. But we think that the present standard, which encourages like-kind exchanges, which results in some one or more parties in the chain resulting in recognition of income from the trading or selling of property ought to be retained.

And with that, I thank you for your time.

Chairman RANGEL. Thank you.

[The prepared statement follows:]

STATEMENT OF NATIONAL REALTY COMMITTEE
TO THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS & MEANS
REGARDING
PROPOSAL TO RESTRICT LIKE-KIND PROPERTY EXCHANGES

September 23, 1993

My name is Stefan F. Tucker and I am a stockholder in the law firm of Tucker, Flyer & Lewis in Washington, D.C. I am pleased to have the opportunity to present testimony today on behalf of National Realty Committee (NRC) regarding a proposed revision to the rules relating to tax-deferred real property exchanges. NRC serves as Real Estate's Roundtable in Washington on national issues affecting real estate. Its members are America's principal commercial and multifamily real estate owners, advisors, builders, investors, lenders and managers.

Summary

When Congress authorized non-recognition of gain or loss on property exchanges in 1924, it did so because of a desire not to impose a tax on a theoretical gain where a taxpayer continued his investment in a "like-kind" property. In addition, Congress recognized that severe administrative burdens would result if all property exchanges had to be evaluated to ensure that each property precisely matched the other. We believe that these concepts remain sound policy considerations today and we support retention of the current law.

The proposal before the Committee would replace the current law "like-kind" standard with a much narrower "similar or related in service or use" standard. The proposed standard is the one now used in determining whether a tax is imposed on the reinvested proceeds received from an involuntary conversion (e.g., property destruction or theft). This standard is appropriate in cases of involuntary conversion because in such cases cash proceeds have been provided to the taxpayer and the taxpayer has direct control over their reinvestment. However, to apply this standard to all property exchanges, as is proposed, where the taxpayers do not receive cash proceeds, would eliminate many economically beneficial exchanges of commercial and residential real estate, farms, ranches, small business real estate, parks, timberlands, mineral interests and other types of real property.

The proposed "similar or related in service or use" standard represents a significant narrowing of the types of exchanges which would qualify for tax deferral. For owners who use their property, it would require that both the physical characteristics and the end uses of the two properties be closely similar to qualify. For owners who lease their property, the "similar use" rules require a close examination of the nature of the taxpayer's relation to the properties. This would present severe administrative difficulties and taxpayer uncertainty. It is interesting to note that the proposed "similar use" standard is one which existed previously for cases involving condemnations of real property. Because of the administrative difficulties it posed for the Internal Revenue Service and because it resulted in significant taxpayer unfairness, Congress modified and liberalized the "similar use" standard for condemnations in 1958 to reflect the like-kind concept.

Taxing exchanges which meet a "like-kind" but not a "similar use" standard would result in taxing phantom income because no cash is received in the exchange to pay the tax -- such a result would be grossly unfair to taxpayers. Most exchanges simply would not go forward if they were taxed as such; therefore, the proposal will not increase Federal revenue by the amount projected. Additionally, taxable transactions now affiliated with multi-party exchanges would in many cases be discouraged because the affiliated exchange would not be undertaken.

The balance of my statement presents a synopsis of current law regarding like-kind property exchanges, explains the proposal to narrow current law and presents several reasons and examples why current law should be maintained.

Current Like-Kind Exchange Rules

Since 1924 Congress has recognized that gain or loss should not be taxed currently when property held for productive use in a trade or business, or for investment, is exchanged solely for property of a like-kind (Internal Revenue Code section 1031). The reason for this rule is that Congress appropriately determined that taxpayers exchanging like-kind property have not altered the level or type of their investment and therefore the economic position of the taxpayer has not changed. Additionally, because an exchange of like-kind property is exactly that, no cash is generated to pay a current tax.

The key concept underlying these rules is the requirement that the property exchanged and that received be of a "like-kind." The like-kind standard refers to the nature or character of the property, not to its grade or quality. For example, improvements on real estate relate to its grade or quality, not to its character as real estate. Therefore, unimproved real property may qualify as like-kind to improved property. In addition to looking to the nature or character of the exchanged properties, the IRS also seeks to ensure that the rights created in, and to, the properties are not substantially different. Under this standard, an assignment of oil payments and an interest in real estate are not like-kind. That's as it should be.

Finally, to ensure that abuse does not occur, current law specifically excludes certain types of property (e.g., partnership interests), requires that the property to be received in an exchange be identified within 45 days, and mandates that the exchange be completed within 180 days following the original transfer.

Although the general current law rule is that no gain is taxed when like-kind property is exchanged, in many transactions there are, in fact, taxes paid. This occurs because cash or other non-like-kind property (boot) received in the exchange is subject to current taxation if such boot exceeds the adjusted basis of the property transferred. Importantly, boot may also include mortgage debt liability which is assumed by the party receiving the property in an exchange. Therefore, to the extent that a taxpayer has received non-like-kind property in an exchange, the existing rules require current taxation.

Moreover, often there are taxable sales which occur before, and in anticipation of, a qualifying like-kind exchange. In such multi-party transactions, a party on one end of the transaction is purchasing property to be exchanged for property that is like-kind. This happens when the owner of like-kind property will not sell but will exchange only because of the high tax cost of selling.

The Proposal and Why It Should Be Rejected

The proposal which is the subject of today's hearing would significantly narrow the range of transactions qualifying for tax-free treatment by replacing the section 1031 "like-kind" standard with the "similar or related in service or use" standard now used under section 1033 in determining the taxation of proceeds that are received from an involuntary conversion and reinvested.

We believe that the current like-kind exchange rules are fundamentally sound and, for the following reasons, we support retention of current law.

Current law is non-abusive and should be maintained. The current rules permitting deferral of tax in a like-kind exchange exist because a taxpayer who exchanges like-kind property has not altered the level or type of its investment, and, therefore, the economic position of the taxpayer has not changed. These rules have worked well for over 60 years. Their flexibility has helped enable all manner and kind of productive exchanges, from single family rental homes to large multi-user rental properties, from farm or ranch property to large unimproved tracts of real property. For example, the rules have helped park management programs obtain unimproved property adjacent to parks by offering developed property in exchange. Farmers and ranchers otherwise faced with once-in-a-lifetime capital gains taxes have retired and exchanged their farm or ranch property for property that could provide retirement income. Many of these beneficial transactions would be curtailed under the proposal to restrict exchange transactions.

The proposed "similar or related in service or use standard" should be rejected because it is too narrow. A "similar or related in service or use" standard represents a significant narrowing of the types of exchanges which will qualify and produces results which are simply unfair to taxpayers. It is the one which must be met under current IRS section 1033 to assure deferral of gain when the cash proceeds from an involuntary conversion are reinvested. It would clearly disallow exchanges of raw land for developed real estate. Thus, owners of unimproved real estate facing extremely high selling costs would not be encouraged to put the land to productive use through an exchange for existing income-producing property, and park managers would not be able to entice trades for unimproved park land by offering developed property.

The proposed standard would be difficult to administer and would create taxpayer uncertainty. The similar use standard also would produce a rule which is administratively much different, depending on whether the taxpayer is an owner who uses the property or an owner who leases the property.

It requires that, in the case of owners who use the property, both the physical characteristics and the end uses of the two properties must be closely similar to qualify for deferral. Under this test, an owner-occupied billiard center has been ruled to not qualify as replacement for an owner-occupied bowling center. The standard also has disallowed replacing a owner-managed motel with an owner-managed mobile home park.

For owners who lease their property, the "similar use" rules require a close examination of the nature of the taxpayer's relation to the properties. That is, are the management activities the same, are the amount of the kind of services rendered to tenants the same, and are the business risks the same? Under this standard, a leased restaurant is not similar to an operated motel, nor is a building used for bank purposes similar to a building leased as office space. There are countless other examples of why the "similar use" standard would be unfair, unworkable and would thwart many exchanges currently qualifying as like-kind.

The bulk of the revenue projected to be derived from taxing these transactions will not materialize. If these proposed changes take effect, most transactions now qualifying as "like-kind" but not qualifying as "similar use" will not be consummated either as exchanges or sales. In fact, revenue from taxable sales in the chain of the multi-party transaction might be lost if the ultimate exchange no longer qualifies for deferral. Overall, this would result in a chilling of real estate markets across-the-country and lessened economic activity in the marketplace.

The proposed standard would impose a tax on phantom income. Taxing like-kind exchanges as sales would result in taxing phantom income. Since any cash received in a like-kind exchange is already subject to tax under current law, and no other cash is received for the property exchanged, insufficient funds are generated with which to pay any additional tax required under this proposal. Moreover, if the taxpayer borrows against the property to satisfy the tax liability, the interest on the borrowed amount is non-deductible.

Conclusion

The proposal to restrict the types of transactions qualifying for tax-free status by replacing the current law "like-kind" standard with a "similar or related in service or use" standard should be rejected. It is unnecessary as there are no examples of abuse under current law. The proposal would be administratively very difficult for the IRS to implement. It would undermine taxpayer confidence and compliance with the tax system and it would halt many economically beneficial property exchanges that otherwise would occur.

Enactment of this proposal would be inconsistent with the steps taken this past summer by this Committee and Congress in the Tax Act of 1993 to rationalize the tax treatment of real estate -- an important sector of the economy, the stability and efficiency of which is key to our national economic recovery and growth.

Thank you for the opportunity to present testimony to the Committee on this important issue. National Realty Committee is prepared to respond to any questions regarding this issue.

STATEMENT OF B. WYCKLIFFE PATTISHALL, JR., VICE PRESIDENT, CHICAGO TITLE & TRUST CO.

Chairman RANGEL. Mr. Pattishall.

Mr. PATTISHALL. Mr. Chairman, members of the committee and staff, I am Wyck Pattishall, a businessman, vice president of Chicago Title & Trust Co., parent of the Nation's largest family of title insurance companies.

The benefits to society which result from a public policy promoting the reinvestment rather than the consumption of the proceeds of sale of capital assets have been acknowledged for centuries. Under feudal property systems, the proceeds from the sale of appreciated property—usually land—were corpus, or capital that had to be reinvested for the benefit of remaindermen, or those who follow.

The gains were not part of the income interest, usually the harvest from the land, and could not be consumed. Well, such restrictions rarely exist under modern property law and so the question remains, if it is good public policy to foster the reinvestment of capital, how can this policy be promoted and enforced? The like-kind exchange provisions of section 1031 promote exactly that type of activity and the proposal to restrict like-kind exchanges to similar use property is, therefore, not good tax policy.

The proposal inappropriately discriminates against investment in real estate at a time when the industry is struggling to recover from the worst recession in four decades. While it may be argued that reducing the number of nonrecognition opportunities is a good idea, it is inappropriate to do so with real estate.

The Tax Reform Act of 1986 exacted an enormous toll on real estate investment and this contributed strongly to the national recession and the weakness of the current recovery.

The recovery period for depreciation on new nonresidential real estate was lengthened from 15 years in 1980, to 18 years in 1984, to 31½ years in 1986, and to 39 years by the Omnibus Budget Reconciliation Act of 1993. The change made by the 1993 Tax Act alone will reduce construction spending by more than $3 billion per year according to economists at DRI McGraw-Hill.

Section 1031 is merely one of several nonrecognition provisions which allow property to be exchanged for other property on a tax-deferred basis. For example, the stock of a privately-held corporation can be exchanged on a tax-deferred basis for the stock of a large publicly held corporation.

There is no reason to allow the owner of a corporation to trade his stock for General Motors' stock without incurring tax, but to require the owner of real estate to pay tax if he trades for other real estate. Most people would view the stock of a publicly traded Fortune 500 company as closer to the equivalent of cash than any real estate could possibly be.

There is no guarantee that the proposal will result in increased revenues. Many taxpayers with appreciated property will not trade or sell, instead preferring to obtain their profits through refinancing. And, furthermore, most like-kind exchanges actually increase revenues.

This is because in the typical exchange the replacement property is acquired in a taxable sale that may have not occurred in the absence of the like-kind exchange. I suspect that the proposed change will result in what economists call a deadweight loss, reflecting a cost imposed on some individuals without any offsetting benefit to others. A pure economic inefficiency.

An example of a deadweight loss was the luxury tax imposed on airplane sales which the joint committee estimated would raise $6 million in revenue in 1991. The actual revenues were $53,000.

Applying the similar related in service or use test to like-kind exchanges, and the like-kind test to condemnations of real property, simply makes no sense at all.

When Congress first enacted legislation on like-kind exchanges in 1921, it provided for nonrecognition of gain only when both properties were of the same like-kind or use. Congress amended the test in 1924, dropping the "or use" provisions and leaving the like-kind provisions, which have remained in effect for the last 69 years. The reason the use requirement was dropped was because it quickly became apparent that in order to prove the use requirement an inquiry must be made to discover the taxpayer's intention at the time of the exchange.

A taxpayer's intent at a particular point in time can only be established by a close examination of the facts in each case. Such an overwhelmingly fact-based test is not the kind of legal standard that lends itself to interpretation by regulatory agencies or appellate courts. If enacted, the proposal will result in substantial confusion, increased litigation, reduced velocity and liquidity in the real estate markets and probably no revenue gain.

Thank you very much.

Chairman RANGEL. Thank you.

[The prepared statement follows:]

U.S. HOUSE OF REPRESENTATIVES
WAYS AND MEANS
SELECT REVENUE MEASURES SUBCOMMITTEE
CHARLES RANGEL, CHAIRMAN

September 23, 1993

Proposal: To amend the like-kind exchange rules under IRC Section 1031 to require that the replacement property be "similar or related in service or use" to the property exchanged, except in the case of condemnation.

Witness:

B. Wyckliffe Pattishall, Jr.
Vice President
Chicago Title and Trust Company
171 North Clark Street
Chicago, Illinois 60601-3294
312-223-2931

Recommendation: That the proposal not become part of any bill.

Testimony: I am B. Wyckliffe Pattishall, Jr., Vice President of Chicago Title and Trust Company, parent of the nation's largest family of title insurance companies.

I am concerned that the proposal is not good tax policy and will only serve to unnecessarily complicate an area that so many, both within the government and outside the government, have tried with some success to simplify in the last few years. Most importantly, I suspect that the proposed change will result in what economists call a "dead weight loss", reflecting a cost imposed on some individuals without any offsetting benefit to others - a pure economic inefficiency. An example of a "dead weight loss" was the luxury tax imposed on airplane sales which the Joint Committee on Taxation estimated would raise revenues of $6 million in 1991. The actual revenues were $53,000.

The benefits to society which result from a public policy promoting the reinvestment, rather than consumption, of proceeds from the sale of capital assets have been acknowledged for centuries. Under feudal property systems, the proceeds of sale of appreciated property, (usually land), were "corpus" or capital that had to be reinvested for the benefit of remaindermen. The gains were not part of the income interest, (usually the harvest from the land), and could not be consumed. Such restrictions rarely exist under modern property law, and so the question remains; if it is good public policy to foster the reinvestment of capital, how can this policy be promoted and enforced? The like kind exchange provisions of Section 1031 of the Code achieve exactly that goal, and the proposal to restrict those provisions is not good tax policy.

Section 1031 is merely one of several non-recognition provisions which allow property to be exchanged for other property on a tax-deferred basis. For example, the stock of a privately held corporation may be exchanged on a tax-deferred basis for the stock of a large, publicly traded corporation. There is no reason to allow the owner of a corporation to trade his stock for General Motors stock without incurring tax, but to require the owner of real estate to pay tax if he trades for other real estate. Most people would view the stock of a publicly traded Fortune 500 company as closer to the equivalent of cash than any real estate could possibly be.

While it may be argued that reducing the number of nonrecognition opportunities is a good idea, it is inappropriate to start with real estate at a time when the industry is struggling to recover from the worst recession in four decades. The Tax Reform Act of 1986 exacted an enormous toll on real estate investment which contributed strongly to the national recession and the weakness of the current economy. The recovery period for depreciation on new, non-residential real estate investment was lengthened from 15 years in 1980, to 18 years in 1984, to 31.5 years in 1986, and to 39 years by the Omnibus Budget Reconciliation Act of 1993. The change made by the 1993 Tax Act alone will reduce construction spending by more than $3 billion per year according to economists at DRI/McGraw Hill. The passive loss rules, the extension of the at-risk rules, the installment sales rules, and the uniform capitalization rules also had a severe adverse effect on the real estate industry.

There is no guarantee that the proposal will result in increased revenues. Many taxpayers with appreciated real estate will not trade or sell, preferring instead to obtain their profits by refinancing. Furthermore, most like kind exchanges actually increase revenues. This is because in the typical exchange, the replacement property is acquired in a taxable sale that might not have occurred in the absence of the like kind exchange.

Applying the "similar or related in service or use" test to like kind exchanges, and the "like kind" test to condemnations simply makes no sense whatsoever.

There are two pragmatic reasons why the "similar or related in service or use" test should not be applied to like kind exchanges. First, the cases interpreting the similar use test in the involuntary conversion area demonstrate no clear doctrine or set of guidelines; the various Circuits have proposed four different tests, with much debate between the courts over the content of two of those tests. The relevance of the physical characteristics of property held for rental income has never been clearly addressed by the courts, ensuring extensive litigation if Congress adopts the proposed amendment. Beyond the unsettled nature of the case law, the proposed change would lead to increased litigation because application of the similar use test is unusually fact-based and therefore less subject to precedential authority developed by the courts. Secondly, Section 1031 once contained a "like kind or use" test. Congress dropped the "or use" language because it found the intention of the party using the property is difficult to determine and unfair as a basis of tax liability. The passing years have made the determination no easier.

I. The Case Law Under IRC Section 1033 Demonstrates Substantial Uncertainty in the Application of the "Similar or Related in Service or Use" Test.

A. Six Circuits and the Internal Revenue Service have developed four different standards for application of the similar-use test to an owner-lessor.

1. The Second, Sixth, and Seventh Circuits, as well as the IRS (Rev Rul 64-237) apply the Liant test: "a court must compare, inter alia, the extent and type of the lessor's management activity, the amount and kind of services rendered by him to the tenants, and the nature of his business risks connected with the properties." Liant 9 AFTR 2d 1557, 1560 (2d Cir. 1962). The Service and the courts have diverged in their application of this standard.

2. Eighth Circuit (Loco Realty 10 AFTR 2d 5359, 5366 (8th Cir. 1962)): "(I)t is sufficient if, coupled with the leasehold characteristics of the taxpayer's properties, there is also a reasonable similarity in the leased premised themselves." This standard does not seem to have been applied in any subsequent cases.

3. Ninth Circuit (Filippini, 11 AFTR 2d 1720, 1722 (9th Cir. 1963)): "The test is a practical one. The trier of fact must determine from all the circumstances whether the taxpayer has achieved a sufficient continuity of investment to justify non-recognition of the gain, or whether the differences in the relationship of the taxpayer to the two investments are such as to compel the conclusion that he has taken advantage of the condemnation to alter the nature of his investment for his own purposes."

The Filippini court specified a list of factors that should be considered in making the determination:

> The broad range of the appropriate inquiry is suggested by Liant's enumeration of relevant factors as including "the extent and type of the lessor's management activity, the amount and kinds of services rendered by him to the tenants, and the nature of his business risks connected with the properties." Since the essential inquiry is whether the taxpayer has committed the condemnation award to a substantially equivalent investment, the relevant facts include all those which would influence an investor in determining the attractiveness of. the respective uses for his capital; the character and location of the particular properties, their potential and actual employment, the state of the market of which each is a part. As Liant suggests and Clifton Investment emphasizes, the relevant facts also include the demands which the respective investments may make upon the taxpayer for supervision and service.
>
> 11 AFTR 2d at 1722 (citations omitted).

Fourth Circuit (Steuart Bros., 3AFTR 2d 318 (3rd Cir. 1958)): This is the first case making the owner-use/owner-lessor distinction. Steuart does not clearly articulate limitations on the similarity of real property held for rental income. Some later cases understand Steuart to hold that all rental properties are similar; other cases interpret Steuart as employing a "same general class test." See Part B(1) infra.

B. The Loco Realty and Steuart tests are themselves unclear.

1. Steuart Bros., 3AFTR 2d 318 (3d Cir. 1958).

Steuart was the first case drawing an owner-user/owner-user lessor distinction, and its statement of the law is ambiguous as to whether all rental properties are of similar use or whether the properties must be in the "same general class." In Loco Realty, 10 AFTR 2d 5359, 5365 (8th Cir. 1962), the court noted the ambiguity in Steuart equally broadly. On the other hand, McCaffrey, 5AFTR 2d 774 (3d Cir. 1960), which is the only circuit to apply the functional use test to an owner-lessor (a position the Service rejected in 1964), understood Steuart as creating the "same general class" test. The district court in Filippini, 9 AFTR 2d 313 (N.D.Ca. 1971), aff'd 11 AFTR 2d 1720 (9th Cir. 1963), reached the same conclusion. (The Ninth Circuit rejected the "same general class" test.)

The Pohn court, 10 AFTR 2d 5780,5782 (7th Cir. 1962), reviewed the overall situation in 1962, before Filippini added yet another test, as follows: "There is a basic difference of opinion between the Third and Second, Fourth and Eighth Circuits, and among the latter three there are shades of difference in the test applied."

2. Loco Realty

Loco Realty's requirement of "reasonable similarity of the leased premises" has been subject to different interpretations by two courts that have cited it. In Pohn, the court interpreted the Loco Realty test as more restrictive than the Second Circuit's Liant test, asserting that "the (Loco Realty) court avoided the extreme statement of the Steuart and Liant doctrine that both properties need only qualify as investments." However, the concurring opinion in Clifton Investment Co., 11 AFTR 2d 649, 651 (6th Cir. 1963), construed Loco Realty as more liberal than Liant. In his concurrence, Judge Miller wrote:

> "I think that the investment character of the properties involved should be given more consideration than what seems to me is given by the ruling in the Liant case, although I do not think that investment basis alone is sufficient to comply with the statute, as Steuart Brothers, Inc. v. Commissioner

> might be construed as holding. As pointed out in Loco Realty Co. v. Commissioner, the statute was not intended to penalize but to protect persons whose property may be taken on condemnation and, accordingly, should be construed liberally. I agree with the standard adopted in the opinion in that case, although for our present purposes I do not think that it results in a reversal of the decision of the Tax Court.
>
> Id. at 651 (citations omitted).

Judge Miller cites Loco Realty here as more liberal than the Liant test, in direct contradiction with the Pohn court.

C. A crucial issue regarding the similar use test remains undecided.

Unlike the functional use test applied to an owner-user, which looks to the property's physical characteristics and end uses, the Service, following Liant, applies a management activity test to an owner-lessor. As long as both properties are used by the taxpayer for rental income, the properties are of similar use if they demand from the taxpayer the same amount and kind of management activity, services and relations to tenants, and give rise to the same business risks. This test seems to completely disregard the physical characteristics of the properties. Indeed, Johnson, 43 TC 736 (1965), permitted the replacement of improved farmland leased to a riding club with urban land leased to a gas station.

In conflict with this line of reasoning, a number of courts seem to have understood that Reg. Section 1.1033(a)-2(c)(9)(i) applies to prevent even an owner-lessor from replacing unimproved with improved realty. These cases imply that similar use requires similar physical characteristics even for an owner-lessor. The unresolved question is the extent to which the character of the property is relevant in the case of a replacement by an owner-lessor.

D. The Filippini test provides for case-by-case decision making by lower courts, ensuring a substantial increase in litigation if this proposal is enacted.

The Filippini test examines "all the circumstances" to reach an overall sense of whether the taxpayer has maintained continuity of investment. The Filippini court expressly rejected any more definite standard. Any test consisting of a broad survey of the circumstances is likely to be an overwhelmingly fact-based exercise. However, the Filippini court went even further, when in n. 4, it cited Duberstein, 363 U.S. 278, 279 (1960):

> Decision of the issue presented in these cases must be based ultimately on the application of the fact-finding tribunal's experience with the mainsprings of human conduct to the totality of the facts of each case. The non-technical nature of the statutory standard, the close relationship of it to the data of practical human experience, and the multiplicity of relevant factual elements, with their various combinations, creating the necessity of ascribing the proper force to each, confirm us in our conclusion that primary weight in this area must be given to the conclusions of the trier of fact.

The court thus expressed its conclusion that the similar use test is not the kind of legal standard that allows appellate courts to clearly guide the lower courts. Instead, each case is different, with the lower courts applying their experience "with the mainsprings of human conduct to the totality of the case." This delegation to the lower courts will substantially increase litigation if applied in the context of like kind exchanges.

II. IRC Section 1031 Was Amended To Remove the Use Test

In 1921, when Congress first enacted the section 1031 equivalent, section 202(c) provided for nonrecognition when both properties were of the same like kind or use. In 1924, Congress amended the test to "like kind" and its reasoning is particularly instructive.

According to a document entitled the "Gregg Statement" released for publication by Chairman Green of the House Ways and Means Committee, and the Senate Finance Committee Report, (Sen. Rep. No. 398, April 1924), the change was intended to respond to the contention that the "like kind or use" test created two classes of property: property held for investment, and property held for productive use in a trade or business. Consequently, it was argued, the "use" language prevented the exchange of properties in different classes. The Gregg Statement and the Senate Report rejected this reliance on use because "the intention of the party at the time of the exchange is difficult to determine, is subject to change by him, and does not represent a fair basis of determining tax liability." Gregg Statement at 11-12; Sen. Rep.at 14.

The "use" requirement was dropped because it quickly became apparent that in order to prove a taxpayer's "use", an inquiry must be made to discover the taxpayer's intention at the time of the exchange. A taxpayer's intent, at a particular point in time, can only be established by a close examination of the facts in each case. Such an overwhelmingly fact based test is not the kind of legal standard that lends itself to interpretation by regulatory agencies or appellate courts.

If enacted, the proposal will result in substantial confusion, increased litigation, reduced velocity and liquidity in the real estate markets, and probably no revenue gain.

STATEMENT OF HOWARD J. LEVINE, MANAGING PARTNER, ROBERTS AND HOLLAND, WASHINGTON, D.C.

Chairman RANGEL. Mr. Levine.

Mr. LEVINE. Good morning, Mr. Chairman, I am Howard Levine, partner with the Washington, D.C. and New York law firm of Roberts and Holland, which specializes only in tax matters. I have been practicing tax law for over 21 years, the first four with the chief counsel's office of the Internal Revenue Service. I am also an adjunct professor of tax law at Georgetown University Law School.

My interest in like-kind exchanges spans my entire career as a lawyer. Although I have several clients who would be affected by this proposal, I have deep academic and nonclient professional interest as well, having written extensively on the area over the years, including authoring the BNA Tax Management Portfolio publication on like-kind exchanges.

In addition, I have previously chaired the American Bar Association Tax Section Subcommittee on Like-Kind Exchanges. I now chair the ABA Tax Section's Sales, Exchanges and Basis Committee, which has primary jurisdiction over like-kind exchanges, although I am testifying today in my individual capacity and not as an officer of the American Bar Association.

I am concerned that the proposal is not good tax policy and will only serve to unnecessarily complicate an area that so many, both within the Government and outside the Government, have tried with some success to finally simplify in the last few years. There are basically two reasons for opposing application of the similar use test to like-kind exchanges:

First, the cases interpreting the similar-use test and the involuntary conversion area demonstrate no clear doctrine or guidelines. The various circuits have proposed four different tests, with much debate between the courts over the content of two of those tests. The relevance of the physical characteristics of property held for rental income has never been clearly addressed by the courts, ensuring extensive litigation if Congress adopts the proposed amendment.

Beyond the unsettled nature of the case law, the proposed changes would lead to increased litigation because application of the similar-use test is unusually fact-based and, therefore, less subject to precedential authority developed by appellate courts.

Second, section 1031 once contained a like-kind or use test. Congress dropped the "or use" language because it found the intention of the parties using the property is difficult to determine and unfair as a basis of tax liability. The passing years have made the determination no easier.

The gist of much of my written statement, which I will not go over, basically outlines and explores the various tests that have been adopted in the different circuits and the conflicting and inconsistent positions that have been adopted among those circuits and how difficult it has been to apply those tests.

A crucial issue regarding the similar-use test also remains. Unlike the functional-use test that has been applied to an owner user, which looks to the property's physical characteristics and end uses, the IRS applies a management activity test to an owner-lessor. As long as both properties are used by the taxpayer for rental income, the properties are of similar use if they demand from the taxpayer the same amount and management activity, services and relations to tenants and give rise to the same business risks.

However, in conflict with this line of reasoning, other courts have understood that the existing regulations in the involuntary conversion area prevent even an owner-lessor from replacing unimproved with improved realty. The question left open, then, is the extent to which the character of the property is relevant in the case of a replacement by an owner-lessor.

The question is a crucial one. It is particularly inappropriate for Congress to apply to transactions as common as exchanges a test with such an important issue unresolved.

There was also, as I said, a prior amendment to section 1031 to remove the use test. In 1921, when Congress first enacted the equivalent to 1031, it provided nonrecognition if properties were of the same like-kind or use. Congress specifically amended 1031 to take out the "or use" provision because it simply was unworkable and not administrable.

The passage of time has made intent no easier to determine. In fact, the frequency of exchanges today compound the difficulties of applying the use test with the likelihood that such a test would have to be applied on a regular basis.

Congress should follow its 1924 decision to provide for a test based solely on the nature and character of the property. There is no overriding necessity to make the proposed change.

In fact, if the change is made, Congress will have to rethink legislation it has recently passed, and is likely to pass in the future, that allows exchanges of ancient forest and mineral rights held by private corporations and individuals for less ecologically sensitive government-owned lands. Unless there is a special provision in the legislation exempting those transactions from income tax, the transferrers of the land could not be assured that the transactions are not taxable, even though such transactions were historically tax deferred.

For all of the reasons stated, as well as the reasons stated in my written testimony, I believe the proposed amendment should not become part of any bill. The IRS, Treasury and taxpayers have worked hard over the past few years to simplify the area of like-kind exchanges so that not every transaction needs the assistance of expensive tax lawyers. The bill would only serve to reverse this trend and to create substantial uncertainty.

Thank you for your consideration.

[The prepared statement follows:]

U.S. HOUSE OF REPRESENTATIVES
WAYS AND MEANS
SELECT REVENUE MEASURES SUBCOMMITTEE
CHARLES RANGEL, CHAIRMAN

September 23, 1993

Proposal: To amend the like-kind exchange rules under IRC §1031 to require that the replacement property be "similar or related in service or use" to the property exchanged, except in the case of condemnation.

Witness:
Howard J. Levine, Esq.
Roberts & Holland
1001 22nd Street, N.W.
Washington, D.C. 20037
(202) 293-3400

Recommendation: That the proposal not become part of any bill.

Testimony:

I am Howard J. Levine, a partner with the Washington, D.C. and New York law firm of Roberts & Holland, which I believe is the largest law firm in the country specializing only in tax matters.

I have been practicing tax law for over 21 years, the first four with the Chief Counsel's office of the Internal Revenue Service. I am also an adjunct professor of tax law at Georgetown University Law School.

My interest in like kind exchanges spans my entire career as a lawyer. Although I have several clients who would be affected by this proposal, I have deep academic and non-client professional interests as well, having written extensively on the area over the years, including authoring the BNA Tax Management Portfolio publication on like kind exchanges. In addition, I have previously chaired the American Bar Association Tax Section Subcommittee on Like Kind exchanges. I now chair the ABA Tax Section's Sales, Exchanges and Basis Committee, which has primary jurisdiction over like kind exchanges, although I am testifying today in my individual capacity, and not as an officer of the American Bar Association.

I am concerned that the proposal is not good tax policy and will only serve to unnecessarily complicate an area that so many, both within the government and outside the government, have tried, with some success, to simplify in the last few years.

There are basically two reasons for opposing application of the similar use test to like kind exchanges. First, the cases interpreting the similar use test in the involuntary conversion area demonstrate no clear doctrine or guidelines; the various Circuits have proposed four different tests, with much debate between the courts over the content of two of those tests. The relevance of the physical characteristics of property held for rental income has never been clearly addressed by the courts, ensuring extensive litigation if Congress adopts the proposed amendment. Beyond the unsettled nature of the case law, the proposed change would lead to increased litigation because application of the similar use test is unusually fact-based and therefore less subject to precedential authority developed by appellate courts. Secondly, section 1031 once contained a "like kind or use" test. Congress dropped the "or use" language because it found the intention of the party using the property is difficult to determine and unfair as a basis of tax liability. The passing years have made the determination no easier.

I. The Case Law Under §1033 Demonstrates Substantial Uncertainty in the Application of the Similar Use Test.

A. Six Circuits and the IRS Have Developed Four Different Standards for Application of the Similar Use Test to an Owner-Lessor.

1. The Second, Sixth and Seventh Circuits, as well as the IRS (Rev. Rul. 64-237) apply the Liant test: "a court must compare, inter alia, the extent and type of the Lessor's management activity, the amount and kind of services rendered by him to the tenants, and the nature of his business risks connected with the properties." Liant 9 AFTER 2d 1557, 1560 (2d Cir. 1962). The Service and courts have diverged in their application of the standard.

2. According to the Eighth Circuit (Loco Realty 10 AFTR 2d 5359, 5366 (8th Cir. 1962)): "[I]t is sufficient if, coupled with the leasehold characteristic of the taxpayer's properties, there is also a reasonable similarity in the leased premises themselves." This standard does not seem to have been applied in any subsequent cases.

3. According to the Ninth Circuit (Filippini, 11 AFTR 2d 1720, 1722 (9th Cir. 1963)): "The test is a practical one. The trier of fact must determine from all the circumstances whether the taxpayer has achieved a sufficient continuity of investment to justify non-recognition of the gain, or whether the differences in the relationship of the taxpayer to the two investments are such as to compel the conclusion that he has taken advantage of the condemnation to alter the nature of his investment for his own purposes."

The Filippini court specified a list of factors that should be considered in making the determination:

> The broad range of the appropriate inquiry is suggested by Liant's enumeration of relevant factors as including "the extent and type of the lessor's management activity, the amount and kind of services rendered by him to the tenants, and the nature of his business risks connected with the properties." Since the essential inquiry is whether the taxpayer has committed the condemnation award to a substantially equivalent investment, the relevant facts include all of those which would influence an investor in determining the attractiveness of the respective uses for his capital: the character and location of the particular properties, their potential and actual employment, the state of the market of which each is a part. As Liant suggests and Clifton Investment emphasizes, the relevant facts also include the demands which the respective investments may make upon the taxpayer for supervision and service.

11 AFTR 2d at 1722 (citations omitted).

4. According to the Fourth Circuit (Steuart Bros., 3 AFTR 2d 318 (3d Cir. 1958)): This is the first case making the owner-use/owner-lessor distinction. Steuart does not clearly articulate limitations on the similarity of real property held for rental income. Some later cases understand Steuart to hold

that all rental properties are similar; other cases interpret Steuart as employing a "same general class test." See Part B(1) infra.

B. The Loco Realty and Steuart Tests are Themselves Unclear.

1. Steuart Bros., 3 AFTR 2d 318 (3d Cir. 1958).

Steuart was the first case drawing on owner-user/owner-lessor distinction, and its statement of the law is ambiguous as to whether all rental properties are of similar use or whether the properties must be in the "same general class." In Loco Realty, 10 AFTR 2d 5359, 536405 (8th Cir. 1962), the court noted the ambiguity in Steuart, leaning toward an interpretation that all rental property is similar under §1033. Pohn, 10 AFTR 2d 5780, 5782 (7th Cir. 1980), cited below, reads Steuart equally broadly. On the other hand, McCaffrey, 5 AFTR 2d 774 (3d Cir. 1960), which is the only circuit to apply the functional use test to an owner-lessor (a position the Service rejected in 1964), understood Steuart as creating the "same general class" test. The district court in Filippini, 9 AFTR 2d 313 (N.D.Ca. 1971), aff'd 11 AFTR 2d 1720 (9th Cir. 1963), reached the same conclusion. (The Ninth Circuit rejected the "same general class" test.)

The Pohn court, a n.4, reviewed the overall situation in 1962, before Filippini added yet another test, as follows: "There is a basic difference of opinion between the Third and Second, Fourth and Eighth Circuits, and among the latter three there are shades of difference in the test applied."

2. Loco Realty

Loco Realty's requirement of "reasonable similarity of the leased premises" has been subject to different interpretations by two court that have cited it. In Pohn, 10 AFTR 2d 5780, 5782 (7th Cir. 1962), the court interpreted the Loco Realty test as more restrictive than the Second Circuit's Liant test, asserting that "the [Loco Realty] court avoided the extreme statement of the Steuart and Liant doctrine that both properties need only qualify as investments." However, the concurring opinion in Clifton Investment Co., 11 AFTR 2d 649, 641 (6th Cir. 1963), construed Loco Realty as more liberal than Liant. In his concurrence, Judge Miller said:

> I think that the investment character of the properties involved should be given more consideration than what seems to me is given by the ruling the Liant case, although I do not think that investment basis alone is sufficient to comply with the statute, as Steuart Brothers, Inc. v. Commissioner might be construed as holding. As pointed out in Loco Realty Co. v. Commissioner, the statute was not intended to penalize but to protest persons whose property may be taken on condemnation and, accordingly, should be construed liberally. I agree with the standard adopted in the opinion in that case, although for our present purposes I do not think that it results in a reversal of the decision of the Tax Court.

Id. at 651 (citations omitted).

Judge Miller cites Loco Realty here as more liberal than the Liant test, in direct contradiction with the Pohn court.

C. A Crucial Issue Regarding the Similar Use Test Remains Open.

Unlike the functional use test applied to an owner-user, which looks to the property's physical characteristics and end uses, the Service, following Liant, applies a management activity test to an owner-lessor. As long as both properties are used by the taxpayer for rental income, the properties are of similar use if they demand from the taxpayer the same amount and kind of management activity, services and relations to tenants, and give rise to the same business risks. This test seems to completely disregard the physical characteristics of the property. Indeed, Johnson, 43 TC 736 (1965), permitted the replacement of improved farmland leased to a riding club with urban land leased to a gas station.

In conflict with this line of reasoning, however, a number of courts seem to have understood that Reg. §1.1033(a)-2(c)(9)(i) applies to prevent even an owner-lessor from replacing unimproved with improved realty. These cases imply that similar use requires similar physical characteristics even for an owner-lessor. The question left open, then, is the extent to which the character of the property is relevant in the case of a replacement by an owner-lessor. This question is a crucial one; it is particularly inappropriate for Congress to apply to transactions as common as exchanges a test with such an important issue unresolved.

D. The Filippini "Test" Provides for Case-by-Case Decision Making by Lower Courts, Implying Substantially Increased Litigation.

The Filippini test, cited above, examines "all the circumstances" to reach an overall sense of whether the taxpayer has maintained continuity of investment. The Filippini court expressly rejected any more definite standard or "rule of thumb." Any test consisting of a broad survey of the circumstances is likely to be an extremely fact-based exercise. However, the Filippini court went even further, when, in n. 4, it cited Duberstein, 363 U.S. 278, 279 (1960):

> Decision of the issue presented in these cases must be based ultimately on the application of the fact-finding tribunal's experience with the mainsprings of human conduct to the totality of the facts of each case. The nontechnical nature of the statutory standard, the close relationship of it to the data of practical human experience, and the multiplicity of relevant factual elements, with their various combinations, creating the necessity of ascribing the property force to each, confirm us in our conclusion that primary weight in this area must be given to the conclusions of the trier of fact.

With this quotation, the court expressed its feeling that the similar use test is not the kind of legal standard that allows appellate courts to clearly guide the lower courts. Instead, each case is different, with the lower courts applying their experience "with the mainsprings of human conduct to the totality of the case." This delegation to the lower courts will substantially increase litigation if applied to §1031.

In one subsequent case, the Tax Court cited Filippini as "[t]he general test to be applied in a qualification under

§1033 controversy." Scheuber, 25 TCM 559, 566 (1966).[1] It appears then that the Filippini test is likely to be applied by at least some courts even outside the Ninth Circuit. The concern about increased litigation is therefore relevant far beyond the reach of the Ninth Circuit. Congress would only exacerbate the problems of an already overloaded judiciary by adopting the similar use test for §1031 exchanges.

II. There was a Prior Amendment to §1031 to Remove the Use Test.

In 1921, when Congress first enacted the §1031 equivalent, §202(c) of the Code provided for nonrecognition when both properties were of the same like kind or use. In 1924, Congress shortened the test to "like kind," and its reasons are particularly instructive.

According to both a document called "the Gregg Statement," released for publication by Chairman Green of the House Ways and Means Committee, and the Senate Finance Committee Report, Sen. Rep. No. 398, April 1924, the change is intended to respond to a contention that the "like kind or use" test created two classes of property: property held for investment and property held for productive use in a trade or business. Consequently, it had been argued, the "use" language prevented the exchange or properties in different classes. The Gregg Statement and the Senate Report rejected this reliance on use because "[t]he intention of the party at the time of the exchange is difficult to determine, is subject to change by him, and does not represent a fair basis of determining tax liability." Gregg Statement at 11-12; Sen. Rep. at 14.

The passage of time has made intent no easier to determine. In fact, the frequency of exchanges today compound the difficulties of applying a use test with a likelihood that such a test would have to be applied on a regular basis. Congress should follow its 1924 decision to provide for a test based solely on the nature and character of the property. There is no overriding necessity to make the proposed change. In fact, if the change is made, Congress will have to rethink legislation it has recently passed, and is likely to pass in the future, that allows exchanges of ancient forest and mineral rights held by private corporations and individuals, for less ecologically sensitive government owned lands. Unless there is a special provision in the legislation exempting those transactions from income tax, the transferors of the land could not be assured that the transactions are not taxable even though such transactions were historically tax deferred.

* * *

For all of the above reasons, I believe the proposed amendment should not become part of any bill. The IRS, Treasury and taxpayers have worked hard over the last few years to somewhat simplify the area of like kind exchanges, so that not every transaction needs the assistance of expensive tax lawyers. The bill would only serve to reverse this trend and to create substantial uncertainty, not to mention numerous and expensive lawsuits. Thank you for your consideration.

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[1] Other Tax Court cases have applied Liant and its progeny.

STATEMENT OF JOHN W. LEE, PROFESSOR OF LAW, COLLEGE OF WILLIAM AND MARY, MARSHALL-WYTHE SCHOOL OF LAW, WILLIAMSBURG, VA.

Chairman RANGEL. Mr. Lee.

Mr. LEE. I am John Lee, a professor at William & Mary.

Chairman RANGEL. Move that mike a little closer to you.

Mr. LEE. And I actually requested to speak on two topics, the soil remediation and this, so I will do a brief one on soil remediation first.

And I think the major thrust I would like to make is that the law is not as clear as the previous panelists indicated; that they should be able to currently deduct the soil remediation costs. There are a few, I think, leading precedents, more recently, that would indicate distortion of income is really what is involved when you are talking about current deduction or capitalization. And if you have an extremely large amount, particularly if it accrued over years, then capitalization, but amortization over some period, is necessary.

Now, that, I think, would answer to some degree the retroactivity argument made by the previous panelists. More than that, I think this committee's greatest concern should be in the fact there are tremendous—the IRS is auditing, there are tremendous amount of cases going to be building up there, and if we let this develop, if Congress lets this develop, as the intangibles developed, one day probably Congress will have to come back in, clean it up anyway, and then handle the retroactivity problems.

So it is much better now to avoid the litigation costs from both the private bar and, for the private taxpayers, and for the Government to address, to give an answer to soil remediation. And I would suggest, probably the answer is, in most cases, a 60-month amortization.

This is not really a repair, in most cases. It is just like the pollution control, the mine safety. It is something the Government is imposing. Probably for good reasons. Certainly for good reasons. And typically the pattern there is 60-month amortization. And there is a future benefit because they don't get closed down.

And, as far as the subsidy to doing it, they have a big stick already. If they don't do it, they don't get closed down. So I don't know that they need the tax incentive.

And very, very briefly, if you buy my argument that our real concern is avoiding litigation costs on both sides, then the whole area of capitalization, in which I have been writing for 20 years and have influenced the tax law, committee reports, various things, and, indeed, that technical advice memorandum, I think, was influenced by me, that area is probably one of the big investor specialization programs. By my count, a quarter of the issues are capitalization or amortization linked to it.

And the GAO study of the 12 most common code sections that generate half of the items in audit and 60 percent of the settlements, one of those is 263 capitalization. A subissue under 162 is capitalization. In short, already it is a big issue and it is going to get much bigger. And it would be so simple for this committee to simply pick out, with the remediation, simply say 60 months. And there are some other narrow areas that probably should get current deduction.

And for the broader thing of capitalization, if you would simply say if it is big—or if it is small, it can be deducted. If it is recurrent, it can be deducted. If it is big, you have to amortize. Give guidelines to the Service to let them start doing the rulings they are doing to build up to regs. That will cut down on litigation.

And the similar thought with 1031, the academic writers all agree as to real estate like-kind is too broad. The real underlying notion being that you should be able to exchange because you have not really economically changed.

We are going from raw land to an apartment building for a little old lady that has held the land for 30 years and then she becomes a passive investor—I am told anecdotally that often happens—that is not economically "like."

In every other area, personal property exchanges under 1031, involuntary conversions, the better cases do apply in economic analysis. But the panel is absolutely right that the wrong thing to do is simply incorporate 1033 and say, hey, go at it. They are absolutely right. The cases are in conflict there. There are better recent cases.

But, again, there, pick out what should be the factors. Probably risk, return and activities. And pick them out, set them in the committee report, and then let the service, by rulings and then regs build it up.

Don't do it the opposite way of detailed legislative regs, 263 Cap-A capitalization comes to mind. Instead, build up, and you can end up with something as beautiful as the 355 regs which allow the fact finder to make the right decision, looking at a number of different factors. We need evolution, but we need direction, and simply doing 1033 won't do it.

Thank you.

[The prepared statement follows:]

TAX POLICY ISSUES RELATED TO LIKE-KIND EXCHANGES AND TO SOIL REMEDIATION COSTS

I am John W. Lee, Professor of Law, College of William & Mary, appearing on my own behalf. I favor, with modifications, the proposals listed in Miscellaneous Issues ## 3 (§§ 1031 and 1033) and 6 (soil remediation costs) in Press Release # 9, August 17, 1993.

SUBSTITUTION OF SECTION 1033'S "*SIMILAR OR RELATED IN SERVICE OR USE*" FOR "LIKE-KIND" IN SECTION 1031 VOLUNTARY EXCHANGES: SORCERER'S APPRENTICE OR ALCHEMIST'S STONE?

I. Introduction

In 1987 the Joint Staffs of the Joint Committee on Taxation and the House Ways & Means Committee suggested either (a) adding real estate to the tainted property exclusions to § 1031 (which the House effected in OBRA 1987 with a $100,000 cap on § 1031 real estate exchanges other than personal residences, or (b) applying the § 1033 "similar or related in service or use" ("SORISOU") standard in lieu of the current "like-kind" standard (which the House also effected in OBRA 1989, but both times these § 1031 restrictions were deleted from the Senate bill and died in Conference). The Joint Staffs reasoned that "1. Nonrecognition on like-kind exchanges is justified only when the taxpayer remains in a similar economic position after the exchange. The like-kind standard as applied to real estate is too broad and flexible to ensure that a taxpayer's economic position is not significantly altered by the exchange, giving investors a tax preference in comparison to investors in productive assets such as stocks and equipment. 2. The like-kind standard for comparing the property transferred with the property received should be no broader than the general standard applying for involuntary conversions. Involuntary conversions are not a tool for tax planning, and give rise to stronger equity reasons for not taxing gain than voluntary exchanges." Staff of Joint Committee on Taxation with Staff of the Committee on Ways & Means, *Description of Possible Options to Increase Revenues Prepared for the Committee on Ways & Means*, 240-41 (JCS-17-87, June 25, 1987); *accord*, H.R. Rep. No. 247, 101st Cong., 1st Sess. 1340 (1989)("The committee believes that it is appropriate to accord nonrecognition only to exchanges and conversions where a taxpayer can be viewed as merely continuing his investment. The 'similar or related in service or use' standard contained in section 1033 (relating to involuntary conversions) better describes the types of transactions that the committee wishes to accord nonrecognition treatment."). The revenue is in the range of 1 billion over 3 to 4 years.[1]

Today this Subcommittee is again considering a "proposal to amend the like-kind exchange rules to require that Code section 1031 property received must be 'similar or related in service or use' to the property exchanged, except in the case of condemnations." I recommend that the Subcommittee adopt this proposal with the modification that **its legislative history set forth the factors (principally risk and management activities) that the Service will apply in rulings which are to evolve from experience into "legislative" regulations** administering structured "discretionary justice". Mere adoption of the current SORISOU standard probably would not exclude as many voluntary exchanges of different grades of real estate as the revenue estimates anticipate due to the quite liberal § 1033 precedent. Although not a Mickey Mouse solution, substitution of SORISOU for "like kind" in voluntary exchanges without further Congressional guidance will create many administrative problems as old issues are needlessly played out again. Just as Disney's Sorcerer's Apprentice did.

II. Origins of §§ 1031 and 1033 Standards for Non-Recognition

The policy basis for non-recognition in like-kind exchanges (as well as involuntary conversions to some extent) is preventing taxation of realizations of "paper" or theoretical" gains or losses, constituting a mere change in form, with continuity of investment without "cashing in".[2] The earlier Treasury 1918

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[1] *Conference Comparison of H.R. 3299, Estimated Revenue Effects of Revenue Reconciliation Provisions* 3 (JCX-70-89 Oct. 26, 1989)($1.341 billion for 1990-94); Levine, *Tax-free Swap Popular among Investors*, NAT'L TAX J. 18 (Monday April 10, 1989); Celis, *Tax-Free Exchange is Again at Stake*, WALL ST. J. B-1, col. 1 (Wed., March 1, 1989)($500 million a year). The down-and-dirty $100,000 annual ceiling on deferrals of gain from real estate exchanges passed by the House in 1987 would have generated slightly more revenue on the average that the more policy based adoption of the § 1033 "similar or related in use" standard. Staff Joint Comm. on Taxation, *Description of Additional Tax Proposals Submitted by Members for Ways and Means Committee Revenue Reconciliation Consideration* (Oct. 13, 1987) (JCT-13-87); H.R. Rep. No. 391, 100th Cong., 1st Sess. 1638 (1987)($992 million for 1988-90). The argument has been raised that so restricting like-kind exchanges will due to "lock-in" decrease multi-party transactions and, hence, the attendant recognition (and resulting revenues) by at least one other party to the multi-party transaction. *See* Wasserman, *Mr. Mogul's Perpetual Search for Tax Deferral: Techniques and Questions Involving Section 1031 Like-Kind Exchanges in a World of Changing Tax Alternatives*, 65 TAXES 975, 978 n.4 (1987). Shades of 1921.

[2] *Compare* H.R. Rep. No. 704, 73rd Cong., 2d Sess. (1934), *with* S. Rep. No. 1983, 88th Cong., 2d Sess. (1958), and Staff, Sen. Fin. Comm, *Explanation of Deficit Reduction Act of 1984*, 98th Cong., 2d Sess. 242 (Comm. Prnt 1984); *accord, Koch v. Comm'r*, 71 T.C. 54, 63-64 (1978). *See generally* Jensen, *The Uneasy Justification for Special Treatment of Like-Kind Exchanges*,

Act Regulation's deferral of tax on gains from involuntary conversions if "the taxpayer immediately proceeded in good faith to replace the property" or established a "replacement fund" was bottomed on the notion that losses in an involuntary conversion and gains or losses on exchanges of substantially similar property were not "closed transactions." Treas. Reg. 45, Art. 49. The causes for the early involuntary conversion rule (without statutory authority) were WW I government condemnations for war production and "submarining" of vessels by "U-Boats". Treasury, *Notes on the Revenue Act of 1918 (1919)*; *(Confidential) Hearings on H.R. 824 (Revenue Act of 1921) before the Senate Finance Committee*, 67th Cong., 1st Sess. 203 (1921)("Dr. Adams' Statement").[3] The 1918 Act regulations also contained a skeletal form of the *continuity of investment* concept and a "*like-kind*" requirement as to non-recognition exchanges of property in its definition of "realization" as arising upon a conversion of property into cash or other property to the extent of replacement property "(*a*) that is essentially different from the property disposed of and (*b*) that has a market value. In other words, both (*a*) a change in substance and not merely in form, and (*b*) a change into the equivalent of cash, are required to complete or close a transaction from which income may be realized." Treas. Reg. 45, Art. 1563. Treasury and the courts, however, interpreted the 1918 Act property exchange provision narrowly, e.g., taxing an exchange of farms (which then and now are more readily marketable than stock in close corporations).[4]

The Revenue Act of 1921, in which the predecessors to §§ 1031 and 1033 first appeared, was enacted by a Republican-controlled Congress and a new Republican Administration which had campaigned on cutting income taxes. Special Treasury Adviser Dr. Adams was more worried about taxpayers taking losses during the post-World War I depression than their deferring gains. *1921 Confidential Senate Hearings*, *supra* at 28-9, 199, 200. He therefore persuaded the Senate to limit realization in exchanges of property to where the property received in the exchange had a readily realizable market value. But even if it had such a readily realizable market value,[5] "no gain or loss shall be recognized--(1) when any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a *like-kind or use*"). *1921 Confidential Senate Hearings*, *supra* at 200 (Dr. Adams reading statute)(Emphasis supplied). Dr. Adams was in such a quandary as to nonrecognition of investment losses and *gains* that he left to the Senate Finance Committee the decision whether to include investment property in the non-recognition net of "like-kind or use". *Id.* at 201. It deleted "for investment" from this first like-kind exchange provision under the rationale that "whatever will make the bill least complicated and less calculated to drive people to insanity is the thing to do." *Id.* at 201. (Statement of Chair Penrose, R-Pa.). Secretary of the Treasury Mellon, however, persuaded the Conference Committee to restore non-recognition to exchanges of investments. These developments set the stage for populist Ways and Means Member John Nance "Cactus Jack" Garner, D-Tex. (early 1930s Speaker of the House and then Vice President during the first two terms of President Franklin D. Roosevelt), to declaim in the House debate on the Conference bill in 1921 about Congress following the mandates of a Treasury Department which desires "to relieve the heavy taxpayer from his taxes and continue the taxes upon the masses of the people ...", and a Treasury expert changing his mind at Mellon's direction.[6] Incredibly, there's more to the story. High income taxpayers responding to brokerage firm advertisements "swapped" appreciated public *stock* or securities which were covered by the original predecessor to § 1031, perhaps even receiving cash "boot" then tax-free up to their basis, and sold their loss securities which, due to Senate intransigence, then resulted in an ordinary loss. Congress estimated the revenue loss to be $20,000,000 to $50,000,000 a year. 64 CONG. REC. (Part 3) 2851 (House February 1, 1923)(Remarks of House Ways & Means Chair Greene, R-Iowa)(about 5%

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4 AMER. J. TAX POLICY 193, 203, 205 (1985); Scott, *Like Kind Replacement Property: Animal, Vegetable, or Mineral*, 23 SAN DIEGO L. REV. 1067, 1068-69, 1076-77 (1986) (traces history of "continuity of investment" back to Civil War ruling). Historically this policy was effected primarily through the "exchange" requirement and secondarily through the "like-kind" prerequisite. *See* Scott, *supra* at 1069; Bryce, *Deferred Exchanges: Non-recognition Transactions after Starker*, 56 TULANE L. REV. 42, 45-46 (1983). For development of the "continuity of investment" concept in the regulations see Kornhauser, *Section 1031: We Don't Need Another Hero*, 60 SO. CAL. L. REV. 397, 407 n.19 (1987); Scott, *supra* 23 SAN DIEGO L. REV. 1068-72, 1091-94.

[3] Carlton Fox so designated these Hearings. Dr. Adams, was the Tax Adviser to the Secretary of the Treasury-- a Yale Professor of Economics who had been at Treasury since 1917 or so and was the leading income tax expert in part because he had directed the Minnesota experiment with the first state income tax commencing around 1909.

[4] O.D. 429, 2 C.B. 38 (1920); *1921 Confidential Senate Hearings*, *supra* at 27 (Dr. Adams); *Pearce, et al., Trustees v. Comm'r*, 13 B.T.A. 150, 151 (1928).

[5] Publicly traded probably was meant, *see 1921 Confidential Senate Hearings*, *supra* at 199-200 (Statement of Dr. Adams); Treas. Reg. 45, Art. 1563.

[6] "We had a Treasury expert there who came in in the morning and made a very interesting and, I thought, conclusive argument; then the Secretary of the Treasury would give him different instructions, and in the afternoon he would make the most conclusive argument on the other side of the same proposition that I ever heard in my life. 61 CONG. REC. (Part 8) 8073 (November 21, 1921 House)(Remarks of Rep. Garner, D-Tex.).

of income tax revenue from individuals). In 1923 Congress held a special Fourth Session just to wrestle with the tax problems of like-kind exchanges. Both tax writing committees took the straightforward 1921 Senate Finance Committee path of deleting "for investment" from the required purpose for holding the exchanged properties. H.R. Rep. No. 1432, *Exchange of Property*, 67 Cong., 4th Sess. 1-2 (1923). This time the Congress *itself* added back "for investment" in a floor amendment at the suggestions of Ways and Means Member and former Chair Rep. Fordney, R-Mich., (1) to keep investments in general under the predecessor to § 1031 and instead (2) list tainted assets not qualifying for a tax-free like-kind exchange including securities. Cactus Jack explained that Fordney had been "out in the West" and absent from the Ways and Means Committee meeting adopting the bill, "perfect in form and substance", that deleted "for investment" and hurried back "post haste" to preserve non-recognition for "blocking up" swaps with the Department of the Interior of coal and timber lands out West. 64 CONG REC. (Part 3) 2852 (House Feb. 1, 1923)(Remarks of Rep. Garner, D-Tex.).[7] Fordney responded that Garner was a "big ear of corn in a little shuck". (By 1940 FDR may have shared that sentiment.)

The origin of the existing distinction in the Treasury regulations between (a) real estate with all grades or qualities being like and (b) personal property which implicitly is like only as to narrow categories is also interesting if less titillating. Dr. Adams provided in the Confidential 1921 Senate Hearings a widely quoted (as not too helpful) example of like-kind exchanges (including investments): "DR. ADAMS. An illustration would be where stocks were exchanged--stocks for stock or bonds for bonds for bonds--or where a factory was exchanged for another factory." Notice implicit narrow categories. The principle that all real estate is "like kind" appears extrapolated from Dr. Adam's less well-known example of a qualifying trade of a farm for a depreciable (rental) house. *1921 Confidential Senate Hearings*, *supra* at 205 (Statement of Dr. Adams explaining substituted basis). The 1921 Act regulations faithfully followed[8] the above hints dropped by Dr. Adams, adopting the following "standards" still contained in Treas. Reg. § 1.1031(a)-1(b) or administrative rulings and current case law. (1) "*Like kind*" refers to the "nature or character of the property and not its grade or quality." Treas. Reg. 62, Art. 1566(a); still contained in Treas. Reg. § 1.1031(a)-1(b). Thus, "the fact that any real estate involved in an exchange is improved or unimproved makes two differences, for such facts relate only to grade or quality of the property and not to its kind or class." *Id.* The courts soon thereafter and to this day have applied the "like kind" standard liberally to interests in real estate of *all* grades and qualities.[9]

More recently both Congress and the courts have taken an "**economic analysis**" of "like kind" as to **personal property**. *Cal. Fed'l Life Ins. Co. v. Comm'r*, 76 T.C. 107 (1981), *aff'd*, 680 F.2d 85 (9th Cir. 1982)("where a taxpayer's economic situation after the exchange is fundamentally different from its economic situation prior to the transaction, the exchange does not encompass like-kind properties."); *Cf.* S. Rep. No. 552, 91st Cong., 1st Sess. 102 (1969)("male calves ... are not held for breeding purposes and, in fact, are not of a 'like-kind' with females."). Cutting to the chase, a similar economic analysis now prevails under § 1033, sometimes quite liberally applied. Many but not all commentators believe that such an economic analysis goes a long way towards rationalizing the host of like-kind rulings and fewer cases as to personal property. While such economic analysis appears correct on a policy basis, i.e., sufficient shifting in risk makes property not "economically similar," *cf.*, H.R. Rep. No. 391, 100th Cong., 1st Sess. 1039 (1987), its current inapplicability to real property exchanges creates economic inefficiencies. *See Joint Staff's Possible Revenue Options*, *supra* at 241. The revised "like-class" safe harbor for exchanges of personal property take an overly restrictive definitional approach to "like class" safe harbors possibly due to the absence of case law or statutory support. Such strictness probably arises as well from the Service's well-taken opposition to the notion that entire businesses could be exchanged under § 1031.[10] Should Congress wish to follow such a narrow approach as to exchanges of personal and intangible property in revising § 1031, it should approve the concept of such "like class" personal property regulations. I recommend in Part IV a hopefully sounder approach of setting forth guidelines as to an economic analysis (risk and management activities) of SORISOU for IRS rulings which in an evolutionary fashion ultimately would be "codified" in structured "discretionary justice" regulations in the manner of the 1989 revised regulations under § 355.

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[7] This was such a good story that it grew with the telling to account for the capital gains preference itself. 65 CONG. REC. (Part 3) 2846 (House February 20, 1924)(Remarks of Rep. Oldfield, D-Ark.) Former House Ways & Means Chair Wilbur Mills, D-Ark, recounted that memories of sitting on the knee of Congressman [Oldfield] lead him to aim for business and Congress in life rather than his father's goals for him.

[8] Carlton Fox, the original compiler of the 1909-1950 Legislative Histories (reprinted in 1979 by William S. Hein, Reams, Ed.), annotated "Dr. Adams' Statement" in the *1921 Confidential Senate Hearings* crossreferencing Act Sections, floor debate, etc. *See* vols. 95 and 95A REAMS, INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 HISTORIES, LAWS AND ADMINISTRATIVE DOCS (William S. Hein & Co. 1979). I suspect that the regulation drafters did the same.

[9] *Koch v. Comm'r*, 71 T.C. 54, 65 (1978)("§ 1031(a) requires a comparison of the exchanged properties to ascertain whether the nature and character of the transferred rights in and to the respective properties are substantially alike. In making this comparison, consideration must be given to the respective interests in the physical properties, the nature of the title conveyed, the rights of the parties, the duration of the interests, and any other factor bearing on the nature or character of the properties as distinguished from their grade or quality. Significantly, as the standard for comparison, section 1031(a) refers to property of a like--not an identical--kind. The comparison should be directed to ascertaining whether the taxpayer, in making the exchange, has used his property to acquire a new kind of asset or has merely exchanged it for an asset of like nature or character.").

[10] *See* Rev. Rul. 89-121, 1989-2 C.B. 203; *Multi-Asset Exchanges, Business Swaps*, 73 J. TAX'N 18 (1990).

How the § 1033 "similar or related in service or use" standard came to be more narrow as to real estate than § 1031 too makes a long story, also largely turning on historical accidents. The "classic" involuntary conversion was loss of an ocean freighter to "submarining" or "condemnation" of a factory by the government for war production during World War I when (a) immediate replacement was often impossible and (b) high wartime taxes (including corporate excess profits taxes)--10% x preWar rates--on gain (inflated in part by war shortages), all taxed as ordinary income, would render replacement impossible after taxes. *See American Nat'l Gas Co. v. United States*, 279 F.2d 220, 225 (Ct. Cl. 1960). Albeit without statutory basis, the 1918 Act Regulations (Treas. Reg. 45, Art. 47) provided that the amount received by the taxpayer (a) for property lost or destroyed in whole or in part through fire, storm, shipwreck, or other casualty or (b) where title was lost through requisition or eminent domain (or voluntary conveyance induced by reason that a proceeding for such a purpose is imminent) was taxable only to extent gain exceeded the amount actually and reasonably expended to "replace or restore the property *substantially in kind*, exclusive of any expenditures for additions or betterments. The new or restored property *effects a replacement in kind only to the extent that it serves the same purpose* as the property which it replaces *without added capacity or other element of additional value*." *Id.* (Emphasis added). The regulation was not explicitly elective, only transactionally so. Treasury Staff suggested a statutory amendment (even more bare bones than the regulation) providing for a "replacement fund for the replacement in kind of lost or damaged property" based on a hardship policy. *Notes on the Revenue Act of 1918*, Section 213(e), *supra* at 15.

The Revenue Act of 1921 which introduced the first "like-kind" tax-free exchange provision also birthed the first statutory involuntary conversion provision (actually 2, one for corporations and one for individual taxpayers) retroactively applicable to 1918. The 1921 Act involuntary conversion regulations added little to the statute, Treas. Reg. 62, Art's 261-63, probably because 1918 Act regulations already existed. Although the 1921 predecessor to § 1033 employed a deduction mechanism (changed to an exclusion of gain in 1924), the drafters of the Revenue Act of 1921 clearly saw involuntary conversions and like-kind exchanges as related as evidenced by their propinquity in discussion in the 1921 Confidential Senate Hearings and even more by the similarity in descriptive terms of the continuity of investment standard in those Hearings and in the 1921 Floor Debate on the predecessor to § 1033. *1921 Confidential Senate Hearings*, *supra* at 55, 203; 61 CONG. REC. (Part 5) 5201, 5296 (House Aug. 18-19, 1921)(Remarks of Rep. Hawley, R-Ore.); Scott, *supra* 23 SAN DIEGO REV. at 1075; *see also Filippini v. United States*, 200 F. Supp. 286, 295 (N.D. Calif. 1961), *aff'd*, 318 F.2d 841 (9th Cir. 1963). Furthermore, the 1921 version of both provisions employed parallel "kind" and "use" tests: ***"like kind or use"*** in the case of the predecessor to § 1031 and ***"character similar or related in service or use"*** in the case of the predecessor to § 1033. This parallelism disappeared in the Revenue Act of 1924. I suspect that Congress thought that at least the two original formulations of the qualifying standard under the predecessors to §§ 1031 and 1033 were essentially the same.

The involuntary conversion provision in the succeeding revenue acts and the income tax regulations under them continued largely unchanged until the regulations under the Revenue Act of 1934 were reworked apparently to reflect ruling and litigation experience over the preceding decade, particularly heavy on the eve of these regulatory revisions. Treas. Reg. 86, Art. 112(f)-(1).[11] For example, the 1934 Act regulation's involuntary conversion provisions for the *first time* set forth rules in the following areas: (A) *tracing requirement for proceeds* of involuntary conversion expended for replacements; (B) *amounts retained* by the government from a condemnation award *to satisfy liens and liabilities are included in the amount of the net condemnation award*, (C) *expenditures* for replacement property *in excess of recovery for the loss are not currently deductible* as a loss, (D) the involuntary conversion provisions apply to *"residential" and "farming purposes"*, (E) *use and occupancy insurance* proceeds do *not* constitute *involuntary conversion proceeds*, and (F) "[t]here is no investment in property similar in character and devoted to a similar use if- (1) The proceeds of unimproved real estate, taken upon condemnation proceedings, are invested in improved real estate. (2) The proceeds of conversion of real property are applied in reduction of indebtedness previously incurred in the purchase of a leasehold. (3) The owner of a requisitioned tug uses the proceeds to buy barges. (4) An award for property taken for street widening is applied toward payment of special assessments for benefits accruing to the remaining property." Treas. Reg. 86, Art. 112(f)-1. Pre-1935 case law authority existed on all of the above rules except (D) and (F)(3) and (4) and cases were in the pipeline as to (F)(4). The then extant (and later) precedent did not always support, however, the positions taken in the regulations.

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[11] Ironically the Revenue Act of 1934 itself had not changed the involuntary conversion provision and, indeed, there was no significant statutory change through the original 1939 Code. *See Filippini v. United States*, *supra* at 295.

Courts initially relying upon the remedial policy of the predecessors to § 1033, particularly prior to the 1934 Act regulations, fashioned a host of liberal rules[12] and in particular early on applied the SORISOU standard liberally as to involuntary conversions of real estate.[13] But in the 1950s the Tax Court and some other tribunals adopted a "functional" test for determining whether replacement property for involuntarily converted real estate was "similar or related in service or use" which in devolution spawned "too many different 'tests' and an acute case of hardening of categories." *Johnson v. Comm'r*, 43 T.C. 736, 736 (1965)(ct. reviewed)(abandoning functional test). The Tax Court dealing with fact patterns where the taxpayer itself was the actual user came to compare the actual physical use to which the exchanged properties were put, but extended this analysis to the lessee's end use where the taxpayer was the lessor. *Loco Realty Co. v. Comm'r*, 306 F.2d 207, 210-13 (8th Cir. 1962)(sketching evolution of test and rejecting it as to lessor exchanges).[14] In 1958 Congress disapproved of application of the functional test as to involuntarily converted real estate but took the easy way out with new § 1033(g) deeming § 1033's SORISOU standard satisfied by meeting the § 1031 like-kind test in the case of real estate *involuntarily converted.* S. Rep. No. 1983, 85th Cong., 2d Sess. 72-73 (1958). I suspect that this view of the relative strictness of SORISOU as to real estate compared to "like kind", which many commentators share, underlay the Joint Staff's reasoning in 1987 that the standard for voluntary exchanges of real estate should be no broader than the involuntary conversion standard. However, the 1958 amendments and legislative history rekindled the remedial flame--courts again wrought creative solutions.

After 1958 courts proceeded to reconstruct the "similar or related in service or use" standard in a line of cases culminating during the early 1960's in *Liant Record, Inc. v. Comm'r*, 303 F.2d 326 (2d Cir. 1962), and its brethren, if not progeny. *Liant Record* stresses the service or use which the properties have to the taxpayer-*lessor*, not the lessees, measured by management activity, services rendered to the tenants, and business risk. Ultimately the Service and the Tax Court adopted this test as to SORISOU.[15] *Davis v. United States*, 589 F.2d 446, 450 (9th Cir. 1979), tests the limits of analyzing the taxpayer's "relationship to the property" (management activities and investment risk) under the SORISOU standard, holding that the taxpayer's reinvestment of condemnation proceeds from disposition of *a fishery plant and adjacent agricultural land* into *improvements to its existing industrial park* land qualified under SORISOU. (The Ninth Circuit, famous for its liberality as to § 1031, noted that "given the change in the Hawaiian economy, *reinvestment in agricultural property was*

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[12] "[F]orthwith . . . acquisition" permitted a 2-year, diligent search for replacement property, *Hoberland v. Comm'r*, 25 B.T.A. 1370 (1932)(also sizing manufacturing for textile industry is "related" but not "similar" in use to old textile plant self-manufacturing its own sizing); anticipatory replacement, *Washington Market Co. v. Comm'r*, 25 B.T.A. 576 (1932); liberal "related use"; *Henderson Overland Co. v. Comm'r*, 4 B.T.A. 1088, 1092 (1926)(land with foundation put in, construction halted by external circumstances for replacement improved real estate used similarly to end goal of converted property). Remedial policy also gave birth later to liberal doctrines. E.g., economic unit rule, *Masser v. Comm'r*, 30 T.C. 741 (1958); timely replacement by purchased controlled corporation after its purchase (pursuant to step transaction doctrine), *John Richard Corp. v. Comm'r*, 46 T.C. 41 (1966); contingencies in purchase price, *Cusack v. Comm'r*, 48 T.C. 156 (1967); "threats" of condemnation, *S & B Realty Co. v. Comm'r*, 54 T.C. 863 (1970); sales under "threat" to third party, *S.H. Kress & Co. v. Comm'r*, 40 T.C. 142 (1963); and "severance" and reimbursements, *Graphic Press v. Comm'r*, 523 F.2d 586 (9th Cir. 1975).

[13] *See*, e.g., *Henderson Overland Co. v. Comm'r*, 4 B.T.A. 1088, 1092 (1926)(lot with taxpayer excavations and foundations for structure, where construction for auto sales office building not completed because WW I war shortages and then condemnations, for lot with building already improved for that purpose); *Washington Market Co. v. Comm'r*, 25 B.T.A. 576, 584 (1932)(ice plant, cold storage refrigeration, and wholesale stalls replaced with property used for all these purposes except wholesale stalls); *Haberland v. Comm'r*, 25 B.T.A. 1370 (1932)(textile manufacturing plant including self-production of sizing materials for own use replaced with plant for making sizing materials for sale to textile mills); *Davis Regulator Co. v. Comm'r*, 36 B.T.A. 437 (1937)(manufacturing business in leased building replaced by self-construction of plant for same business on land owned by taxpayer); *Kimbell-Diamond Milling Co. v. Comm'r*, 10 T.C. 7 (1948)(flour plant replaced by flour and feed processing plant); *Massillon-Cleveland-Akron Sign Co. v. Comm'r*, 15 T.C. 79 (1950)(plant replaced by plant for similar manufacture but with disproportionate mix of assets); *Gaynor News Co. v. Comm'r*, 22 T.C. 1172, 1179 (1954)(unimproved real estate acquired as plant site for real estate with existing improvements usable in part for the new plant; "we think it unrealistic to set up a functional classification in terms of improved or unimproved property").

[14] *Liant Record, Inc. v. Comm'r*, 303 F.2d 326, 328-29 (2d Cir. 1962), in dictum accepted the "functional" test *only* where the taxpayer him or herself used the converted property. *Pohn v. Comm'r*, 309 F.2d 427, 429 (7th Cir. 1962), would reconcile *Lynchburg Bank & Trust Co. v. Comm'r*, 208 F.2d 757 (4th Cir. 1953), and *Steuart Bros., Inc. v. Comm'r*, 261 F.2d 213 (4th Cir. 1958)(both written by able Judge Soper of the Fourth Circuit) by reading *Steuart* as adopting a *Liant Records*-like double standard. However, an excellent student note convincingly argues that a *Liant Records*-cum-*Filippini* markets risk analysis should apply to both investment and productive business use property for purposes of § 1033. *See* Note, *Involuntary Conversions and the Questions of Qualified Replacement Property*, 38 OHIO ST. L. J. 331, 350 (1977).

[15] Rev. Rul. 64-237, 1964-2 C.B. 319; *Johnson v. Comm'r*, 43 T.C. 736, 739-41 (1965)(ct. reviewed). *See also Loco Realty Co. v. Comm'r*, 306 F.2d 207 (8th Cir. 1962); *Filippini v. United States*, 318 F.2d 841, 845 (9th Cir. 1963).

unreasonable, and purchase of another sea fishery was virtually impossible." Id. at 450 (Emphasis added).) Under such analysis most business (or investment) real property could be swapped for most business real property (or investment real property, respectively). But raw land could not be swapped for a developed real estate investment due to the shift in risk (and current return in most cases). Nor could improved real estate used in a business be swapped for otherwise identical realty held for investment use due to the change in management activities.

In short the conventional wisdom that courts apply § 1033 more strictly than § 1031 appears more wrong than right early and late--less so in between. Nevertheless due to the controversies under §§ 1031's and 1033's standards, Congress this time should not simply adopt the § 1033 standard lock-stock-and-barrel in § 1031 (as the House did in 1989), while keeping the old § 1031 standard for involuntary conversions of real estate under § 1033. It should address at least the known conflicts or uncertainties, if only by approving or disapproving of specific precedent. For example since *Davis* was deliberately decided under § 1033(a), simple adoption of § 1033's "similar or related in service or use" test would support application of *Davis* to a like-kind exchange as well as an involuntary conversion. If Congress wants this result, then there is little need to retain a § 1033(g) like-kind test for involuntarily converted real estate. **Please don't create more clutter in the Code.**

III. Tax Policy and Politics

Continuity of investment was criticized just over a decade after enactment of the first predecessor to § 1031 as a rationale for nonrecognition. *See Prevention of Tax Avoidance, Preliminary Report of a Subcommittee of the Committee on Ways and Means Relative to Methods of Preventing the Avoidance and Evasion of the Internal Revenue Laws Together with Suggestions for Simplification and Improvement Thereof*, 73rd Cong., 2d Sess. 8-9, 38-9 (1933)(Subcommittee and Joint Committee Staff discounted "paper profits" rationale). More recently criticism of § 1031 has centered on (a) its overly restrictiveness--in inconsistent treatment of cash-outs with (contractually) required reinvestment and non-like-kind exchanges of illiquid property, Kornhauser, *supra* 60 **So. Cal. L. Rev.** at 409-11; Jensen, *supra* 4 **Amer. J. of Tax Policy** at 204; Comment, *Exchange Requirement in Multiparty and Nonsimultaneous Exchanges: A Critical Analysis and Statutory Solution*, 37 **Sw. L.J.** 645, 646-47 (1983); (b) its over liberality in providing non-recognition for transactions which substantially change the form of investment as to the nature of risks and rewards, Bryce, *supra* 56 **Tulane** at 46; and (c) the overly narrow "like class" safe harbors for personal property and particularly the new like kind rules in these regulations as to intangibles, Bogdanski, *On Beyond Real Estate: the New Like-Kind Exchange Regulations*, 48 **Tax Notes** 903, 904, 908 (Aug. 30, 1990).

The primary, usually (unstated policy) in allowing non-recognition for like-kind exchanges is the economic analogy to unrealized appreciation or depreciation, which in a continuing investment is not taxed or recognized until realized. *See* Jensen, *supra* 4 **American J. of Tax Policy** at 199-201 (1985). However, there the principal (non-political) basis for non-recognition is (a) administrative convenience--annual valuations and self-reporting--and (b) lack of taxpayer liquidity. The focus in administrative difficulties is on (1) difficulty of "valuation" in "thousands of horse trades and similar barter transactions each year." H.R. Rep. No. 704, *supra* at 564; *Hearings on Tax Shelters, Accounting Abuses, and Corporate and Securities Reforms, before the House Ways & Means Comm.*, 98th Cong., 2d Sess. 11, 24 (1984)(Statement of Ass't Sec'ty Chapoton); and (2) hence, difficulty in compliance, Jensen, *supra* at 208-11. As to valuation, at least "boot" and multi-party transactions practically require valuations. *See* Jensen, *supra* 4 **Amer. J. of Tax Policy** at 209; Kornhauser, 60 **So. Cal. L. Rev.** at 409; Comment, 37 **Sw. L.J.** at 648 (boot requires valuation); Briar, *Like-Kind Exchanges of Partnership Interests: A Policy Oriented Approach*, 38 **Tax L. Rev.** 389, 401 n.47 (1983). As to compliance, this too probably is only a problem in true barter situations, hence, the appropriate remedy is a ceiling on the dollar amount of deferrable gain in non-recognition transactions. *Cf.* the $100,000 annual taxpayer ceiling on § 1031 exchanges of real estate under the House version of OBRA 1987.

The 1921 enactment of the like-kind exchanges was part of a package (including limiting "amount realized" to property with a readily realizable market value) designed to make more trades not currently taxable in order to defer recognition of stock losses during the then current post-war depression. *See Hearings on H.R. 8245 (Revenue Act of 1921) before Sen. Fin. Comm.*, 67th Cong., 1st Sess. 199-202 (1921)(Statement of Dr. Adams); *accord*, *Greene v. Comm'r*, 15 B.T.A. 401, 407 (1929)(*Board reviewed*), *aff'd*, 42 F.2d 852 (2d Cir. 1930). Congress' continuation in 1934 of the non-recognition provisions in general, which the House would have repealed, also was based on the fear that recognized losses in the heart of the Depression would have exceeded recognized gains. Jensen, 4 **Amer. J. Tax Policy** at 211-12 and n.86. However, with chronic and at times substantial inflation over the past 25 years, this policy has become anachronistic. *Id.* at 212.

Professor Kornhauser, utilizing historical research, has convincingly hypothesized several factors involved in the enactment of § 1031 in 1921 and the amendments in 1923 and 1924: (1) concern about whether capital gains were income; (2) confusion about when realization occurs; (3) sympathy for a consumption theory of income taxation; and (4) economic and political conditions encouraging an economic policy in the tax laws to foster investment. Kornhauser, 60 **So. Cal. L. Rev.** at 411; *see also id.* at 400, 438-39 (trick was for Congress to encourage investment while maintaining nominally progressive rates, which capital gains preference and tax-free like-kind exchanges accomplished), *accord id.* at 440-41. The legislative history in Part II confirms that the architects of § 1031 at least intended for the predecessors to § 1031 and to the corporate reorganization provisions to act as a back-door consumption tax for high income individuals, i.e., reinvest and you won't be taxed; don't and you will albeit at not very high capital gains rates.

The economic efficiency argument too was present in the genesis of § 1031: mere changes in form should not impede business transactions, H.R. Rep. No. 350, 67th Cong., 1st Sess. 10 (1921); 64 **Cong. Rec.** (Part 3) 2855 (House Feb. 1, 1923) (Remarks of Rep. Green, R-Iowa); Kornhauser, 60 **So. Cal. L. Rev.** 408 n.25, and underlies the limitation to business or investment property and even more the exclusion *ab initio* of personal use property. Jensen, 4 **Amer. J. Tax Policy** at 213 n.94. However, this rationale too is flawed in that the "like-kind" test actually channels otherwise "locked in" assets only to "like-kind" investments rather than to the best user and uses the barter mechanism entailing high transactional costs. Jensen, 4 **Amer. J. Tax Policy** at 214-15; Kornhauser, 60 **So. Cal. Rev.** at 408 and n.24. Thus, economic efficiency would call for universal roll-over. See authorities cited in Kornhauser, 60 **So. Cal. L. Rev.** at 411 n.31; Blum, *Rollover: An Alternative Treatment of Capital Gains*, 41 **Tax L. Rev.** 383 (1986). In 1987 the Joint Staff's concern focused on continuity of investment, arguing for a § 1033 standard, to prevent (a) significant alternation of economic position and (b) favoring of real estate with its broadest definition of "like" over personalty divided into a host of dissimilar investments. *See also* Kornhauser, 60 **So. Cal. L. Rev.** at 409-11. The general mobility of capital argument cuts too broadly in that it would call for a general roll-over of asset approach (thus fatally eroding distributional equity as well as vertical and horizontal equity). *See* Kornhauser, 60 **So. Cal. Rev.** at 410. And if incentives for investment are desired--and advisable--better techniques can be designed. *Id.* at 449-50 (IRA-like 90-day rollover technique).

The House Ways & Means Committee in 1987 modified the Joint Staffs' alternative of proscribing real estate from § 1031 exchanges by caping at $100,000 the amount of gain from a like-kind exchange of real estate (other than involuntary conversions and exchanges of principal residences) any taxpayer could have deferred in any one taxable year (presumably responding to the overly liberal application of the like-kind standard to real estate and possibly to fact that most of the abuse was here). H.R. 3445, 100th Cong., 1st Sess. § 10105 (1987). The Committee looked as much at deferral at high income levels as at the traditional continuity of investment criterion (economic similarly to cash or property *not* of a like-kind). H.R. Rep. No. 391, 100th Cong., 1st Sess. 1039 (1987). Probably the former concern relates to the distributional equity of the 1986 Code. However, the 1987 House bill attracted significant attention from real estate professionals who launched an active and successful lobbying effort against the measure. 15 **J. Real Est. Tax'n** 267. Such distributional and special interest group concerns are matters of tax politics more than policy. Here too the picture is mixed. Governor Clinton's primary income tax theme in the 1992 Presidential Campaign was "fairness" or increasing individual income taxes only on the rich. Restricting the scope of like-kind exchanges of investment and business real estate surely would have that effect. On the other hand President Clinton's goal was to couple rate increases at the top with "offsetting incentives to invest." *See* Lee, *President Clinton's Capital Gains Proposals*, 59 **Tax Notes** 1399, 1410 n.62 (June 7, 1993). Similarly while real estate interests *successfully* opposed in 1987 the $100,000 cap on deferred gain in § 1031 exchanges of real estate and the 1989 extension of the § 1033 standard to real estate exchanges under § 1031, at the time such exchanges were highly touted as the only intact individual real estate preference with the repeal of any capital gains preference and imposition of § 469's Passive Activity Loss disallowance rules. OBRA 1993 restored a substantial capital gains preference and carved out from PAL real estate losses of those in the industry. *See* Lee, *supra.* Thus the political case of the real estate sector is weakened. (As an aside, it would have made better policy and politics to have used the revenues from restricting § 1031 to help pay for the PAL changes rather lengthening the depreciable life of real estate so much.)

Commentators and the courts themselves agree that the trend in judicial interpretation of § 1031 (as to "exchange" and "holding" as well as the like-kind standard as to real estate) has been liberal. *See* Bryce, *supra* 56 **Tul. L. Rev.** at 58 (citing *Starker*); Note, *Section 1031 Nonrecognition of Gain for Deferred Exchanges--Starker v. United States*, 16 **Wake Forest L. Rev.** 645, 650-53 (1980); *Starker v. Comm'r*, 602 F.2d 1341, 1352 (9th Cir. 1979). The above discussion shows that the like-kind deferral of investments from its inception was based on benefitting private interests (helping businesses and high income individuals maintain their capital while maintaining the "facade of progressive rates") especially as to like kind exchanges of investments, and indisputably in 1987 and 1989 was maintained as a preference for private interests. Some but not all academic writers believe that in such circumstances special interest benefit legislation should be strictly construed. I would apply this "strict construction" notion to exchanges of investment property. To the contrary the liberal § 1031 "exchange" judicial precedents, coupled with the regulation's broad classification *ab initio* of all real estate as "like" long firmly embedded in the case law, violate both sound tax policies--economic efficiency (tax rules encourage real estate swaps over other swaps and sales); horizontal equity (disparate treatment of taxpayers holding investment real estate and swapping real estate while diversifying risk), and vertical equity (benefits concentrated in high bracket taxpayers). A rationalized post-*Liant Records* SORISOU test applied under §§ 1031 and 1033 (probably more liberally under the latter) to all types of property would help maintain continuity of investment/business characteristics parallel to unrealized appreciation in non-exchanged property.

IV. Proposed Modifications to § 1031 Standard

I respectfully urge this Subcommittee to revise the § 1031 standard for exchange to the SORISOU standard of §1033 because the current generosity to voluntary real estate exchanges violates sound tax policy and comes from tainted historical origins as to investment property swaps. More importantly I implore it not to just adopt the § 1033 "similar or related in service or use" standard (perhaps with a "like kind" standard exception for involuntarily converted real estate), but instead address in the legislative history how a standard comparing risk and management activities (and any other appropriate factors) should be applied in voluntary and involuntary exchanges.[16] Congress should direct in revised §§ 1031 and 1033 (or combined into a single section covering voluntary and involuntary conversions and exchanges) implementation of such policies through revenue rulings which would evolve into regulations employing a "structured discretionary justice" approach. Detailed regulations promulgated by an administrative agency, here Treasury and the Service, increase the principled discretion of the agency as a decision maker, according to Professor Davis' landmark book "DISCRETIONARY JUSTICE — A PRELIMINARY INQUIRY" and subsequent administrative law scholarship.[17] Moreover, Professor Davis posits that such detailed rules channeling agency exercise of discretion can develop from first considering one concrete problem at a time, announcing the hypothetical cases as rulings and refraining from generalizing; then fashioning generalized principles or standards from this experience; and finally formulating regulations to implement the standard in the form of structured discretion.[18]

On another thought, *the narrower the range of permitted exchanges under revised § 1031, the stronger the case for permitting reinvestment within a stated period (say 90 days) of cash proceeds in qualifying replacement property* under such revision.

Most importantly the Subcommittee should take advantage of this opportunity and address in the legislative history known problems under §§ 1031 and 1033 including the areas set forth below. The cast of players in the following hypotheticals include ***A*** who holds the "exchange property" and ***B***, the other party to the exchange who holds the "replacement property", except in some 3 or 4 cornered or party exchanges, and who always winds up holding the exchange property.

1. Built-to-Suit. ***A***'s transfer of real property in exchange for ***B***'s construction of improvement on other property held by ***A*** does not qualify under § 1031. *Bloomington Coca-Cola Bottling Co. v. Comm'r*, 189 F.2d 14 (9th Cir. 1950); Wasserman, *supra* 65 **Taxes** at 979; P.L.R. 8701015. What if to aviod these tax results, ***B*** makes the improvements on parcel ***X***, not previously owned by ***A***, and then exchanges improved parcel ***X*** for a parcel of real estate (usually unimproved) held by ***A***. OK. *J. H. Baird Publishing Co. v. Comm'r*, 39 T.C. 608 (1962), *acq.* 1963-2 C.B. 4 (*A* picked parcel *X*); *accord*, *Coastal Terminal, Inc. v. United States*, 320 F.2d 333 (4th Cir. 1963). ***B*** is not entitled to like-kind treatment on exchange of parcel *X*. Rev. Rul. 75-291, 1975-2 C.B. 332. For a perverse § 1031 flip-flop here by Government see *Barker v. United States*, 668 F. Supp. 1199 (D.C. Ill. 1987)(Government argued for like-kind exchange). What if *A* locates and negotiates for property to be acquired? OK. *Coupe v. Comm'r*, 52 T.C. 394, 405-09 (1969), *acq. in result only*. Oversees improvements on land to be acquired? *J.H. Baird, supra. See generally* Guerin, *A Proposed Test for Evaluating Multi-Party Like Kind Exchanges*, 35 TAX L. REV. 545, 612 (1980); Rev. Rul. 75-291, 1975-2 C.B. 332. A 1980s ploy was for *A* to sell *high basis* parcel *X* to *B*, who concurrently contracted with *A* to build the improvements and then to transfer improved tract *X* to *A* in exchange for *A*'s *low basis* (usually unimproved) parcel *Y*. Again *B* does not qualify for deferral under § 1031. Goldstein & Lewis, *supra* 5 REV. OF TAX'N OF IND'V'S at 207. But *A* does, so long as risk of economic loss as to parcel *X* rests with *B* between acquisition and exchange. P.L.R. 7823035 (*B* bears the fundamental risk of ownership of, the property and of the constructon to take place thereon); *accord*, P.L.R. 8217106 ("including, but not limited to, liability for real estate taxes or for obligations under hte loan or construction agreements, and Corp A will not be entitled to any income, insurance proceeds or condemnation proceeds prior to the exchange date."); Goldstein & Lewis, *supra* 5 REV. OF TAX'N OF IND'V'S at 207. Query, was risk of loss truly on *B*? *See* Wasserman, *supra* 65 TAXES at 980. Also the Eighth Circuit went the opposite way on similar facts under the step-transaction doctrine. *Smith v. Comm'r*, 537 F.2d 972 (8th Cir. 1976). What if *B* does not buy parcel *X*, but instead becomes tenant on a 30-year ground lease? *See* Wasserman, *supra* 65 TAXES at 980-81; *1984 Tax Shelter Hearings, supra* at 159 (Statement of Professor Martin Ginsburg). If *B* is related to the taxpayer, new problems emerge. The deferred exchange regulations contemplate built-to-suit exchanges. Treas. Reg. § 1.1031(k)-1(e)(3)(ii) and (iii). Congress should provide that if the improvements are made on property owned by *A* within the last previous 2 years, an exchange of that property back to *A* will not qualify under § 1031.

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[16] In involuntary conversions but not voluntary exchanges difficulty of replacement could and should be a factor. *See Davis v. United States*, 589 F.2d 446, 450 (9th Cir. 1979). Similarly construction of improvements on already owned property might qualify in an involuntary conversion but all of the current built-to-suit techniques for like-kind exchanges might be denied deferral in a voluntary exchange.

[17] DAVIS, DISCRETIONARY JUSTICE, A PRELIMINARY INQUIRY, 103 (LSU Press 1969); *see also* MASHAW, BUREAUCRATIC JUSTICE, MANAGING SOCIAL DISABILITY CLAIMS 103-22 (Yale Univ. Press 1983); Lee, *Structured Discretionary Justice Under Section 355*, 44 TAX NOTES 1029, 1030 (August 28, 1989). An agency issuing regulations (rule making) setting forth specific factors to be used in balancing tests implementing the desired standards and policies can implement standards effectively while maintaining the desirable bureaucrat's discretionary judgement in application. *Id.* at 1032.

[18] Lee, *supra* note 17 at 1032.

In *Davis Regulator Co. v. Comm'r*, 36 B.T.A 437, 443 (1937), the Board relying on remedial nature of the predecessor to § 1031 permitted tax-free reinvestment of the proceeds of an involuntary conversion of *a leasehold interest* in improved real estate used in the taxpayer's manufacturing business in *construction* of a plant to continue business *on property already owned* by the taxpayer. *Accord*, *Davis v. United States*, 589 F.2d 446 (9th Cir. 1979). *Contra* P.L.R. 8119029. To the contrary, going from raw land used in a cemetery business to construction of an administrative office for the business on retained land did not qualify under the since-discredited "functional or end use" test. *United Development Co. v. United States*, 212 F. Supp. 664, 667-67 (E.D. Mo. 1962)(effect of investing in an administration building is to replace the old building and to enhance the remaining property of the corporation; not a replacement of its income producing asset, the condemned land). Please address this in the Report.

2. Purpose for Holding. Problems have arisen as to the purpose for holding when the taxpayer has recently acquired the exchange property (typically in an exchange basis transaction) to exchange it or disposed of the replacement property shortly after the exchange. The "holding requirement" corresponds to the Subchapter C "*continuity of interest*" doctrine. Therefore, acquiring property for an exchange (at least in a cost-basis acquisition) fails the "holding" requirement. Rev. Rul. 75-291, *supra*. Conversely, immediate sale of the property received in the exchange may equally cause such replacement property to fail the "holding" test and, hence, the exchange to fail § 1031. *See Black v. Comm'r*, 35 T.C. 90 (1960); *Regals Realty Co. v. Comm'r*, 43 B.T.A. 194 (1940), *acq.* 1931-1 C.B. 9, *aff'd*, 127 F.2d 931 (2d Cir. 1942). A 2-year qualified "holding" before and after probably will suffice. *See Section 1031 applied to property held two years*, 61 J. TAX'N 224 (Oct. 1984). The Tax Court views holding the replacement property for a gift as failing the "holding" test where the "step transaction" doctrine applies. *Compare Click v. Comm'r*, 78 T.C. 225, 232-34 (1982)(tax plan to give residences to children plan was completed 7 months after exchange of ranch for residences) *with Wagensen v. Comm'r*, 74 T.C. 653, 660 (1980)(taxpayer had eventual goal but no "concrete" plans to make gift of replacement ranch property; discussions with tax advisers only after exchange; gift made 9 months after exchange). Clearly **a bright-line say 1-year before- and after-exchange holding period as called for by the House in 1989 is infinitely preferable to the current unpredictability.** H.R. Rep. No. 247, 101st Cong., 1st Sess. 1339-40, 142 (1989).

3. *Taxpayer Involvement in Acquisition of Replacement Property.*

Taxpayers understandably often want to play a major part in the acquisition of the replacement property. The taxpayer may want to locate the replacement property and negotiate (or at least approve) the terms of the replacement property contract and any financing to be secured by the replacement property. *See* Rev. Rul. 77-297, 1977-2 C.B. 304. However, if a taxpayer is too actively involved, it may appear that *B* (in a 3-party exchange) or *D* (the "intermediary" in a 4-party exchange) is acting as the taxpayer's agent. Guerin, *supra* at 603. Cases have questionably allowed the taxpayer to advance money to the exchange "intermediary" towards the purchase price of the replacement property. *Biggs* *v. Comm'r*, 69 T.C. 905, 914-15 (1978), *aff'd*, 632 F.2d 1171 (5th Cir. 1981); *See 124 Front St., Inc., v. Comm'r*, 65 T.C. 6, 17-18 (1975) (taxpayer can advance money toward purchase price of parcel to be acquired); Guerin, *supra* at 608-09. *But see* P.L.R. 8035049 (prohibiting loans between the parties for construction). *Cf.* No ruling "red flag" in financing lease/"leveraged leasing" context. One commentator has stated that it may be preferable for a taxpayer to guarantee a loan than for the taxpayer to make that loan. Wasserman, *supra* 65 TAXES at 987. Possibly such in effect acting as the taxpayer's agent in the purchase will be ignored under the qualified intermediary portion of Treas. Reg. § 1.1031(k)-1(k). *See* Cuff & Wasserman, *Understanding the New Regulations on Deferred Exchanges*, 68 TAXES 475, 493 (1990); Committees on Income from Real Property and Personal Properties, New York State Bar Association, Section of Taxation, *Report on Section 1031 Deferred Exchange Regulations*, 48 TAX NOTES 1405, 1415 (Sept. 19, 1990).

4. *Scope of Condemnation*. The Subcommittee may want to consider whether "condemnation" should be limited to eminent domain. *See*, e.g., *American Nat'l Gas Co. v. Comm'r*, 279 F.2d 220 (Ct. Cl. 1960); Rev. Rul. 57-314, 1957-2 C.B. 523; *S & B Realty Co. v. Comm'r*, 54 T.C. 863 (1979), *acq.* 1970-2 C.B. xxi.

5. *Tax Benefit Rule*. An uncertain area is whether the tax benefit rule overrides § 1033. *Compare Mager v. United States*, 499 F. Supp. 37 (M.D. Pa. 1980), *aff'd in unpub. opinion.* (3rd Cir. 1981)(condemnation of property in flood plain based upon pre-flood value resulted in "tax benefit" to extent of casualty loss previously taken by taxpayer as to uninsured flood damage to residence); *Birnbaum v. Comm'r*, T.C. Memo. 1978-429 (same), and Rev. Rul. 74-206, 1974-1 C.B. 197 (same), *with Buffalo Wire Works Co., v. Comm'r*, 74 T.C. 925 (1980), non-acq, *aff'd in unpublished opinion* (2d Cir. 1981)(no tax benefit "recovery" of moving expenses when condemnation award was based in part on reimbursement of moving expenses because of doctrine that components of award are not to be broken out but all treated as compensation for property taken). *See* Edwards, *Involuntary Conversions* **BNA T.M. Portfolio # 33-7th at A-46 (1984).**

SOIL REMEDIATION COSTS: TAMs, TAXES, TOXINS AND BEYOND

I. Introduction

Treasury's highest regulatory priority is the tax accounting treatment of environmental cleanup costs because it hopes to avoid tremendous litigation costs down the road.[1] The [high-end] estimate of such cleanup costs is in the $1 trillion range over 30 years.[2] I hope that this Subcommittee will take the first steps to head off another costly imbroglio like the amortization of intangibles/*Newark Morning Ledger* mess Congress just cleaned up after with the § 197-prospective fix. This time Congress has the opportunity to lock the barn door in time to prevent wasteful Government and taxpayer litigation costs over the deductibility of soil remediation costs (and of expenditures with some future benefit in general). From both a policy and political perspective, the **proper tax accounting for *most* toxic waste removal or cleanup costs** surely is **amortization** as self-created intangibles over a stated period. Such costs are substantial which tends to distort income if allowed as a deduction in one year and usually yield a future benefit by permitting business operations to continue.[3] Handy models for such amortization are either

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[1] Avakian-Martin & Carson, *Environmental Cleanup Issue: A Recurirng Theme at ABA Meeting*, 60 TAX NOTES 925, 926 (August 16, 1993))(Treasury estimate of $1 trillion).

[2] *Peat Marwick Requests Guidance on Proper Treatment of Environmental Cleanup Costs*, 93 TAX NOTES TODAY 148-25 (July 15, 1993)("trillion dollar" range at 37,000 hazardous waste sites based on Associated Press Release, December 9, 1991). Nexis research disclosed no such AP release. The actual source appears to be a University of Tennessee study. Butler, *UT Researchers Release Report on EPA Superfund*, Gannett News Service (Monday December 9, 1991)(December 6, 1991 University of Tennessee Study, *Hazardous Waste Remediation: The Task ot Hand*, estimates costs from $500 billion (containing or managing waste in place) to $1.2 trillion (destroy more site contamination, e.g., more remediation) over the next 30 years, with the "best guess" figure being $750 billion (continuation of current cleanup policies under Superfund, Resource Conservation and Recovery Act, federal facilities, underground storage tanks, state and private cleanup efforts); study estimated that it will cost about $151 billion to correct environmental problems at the highly publicized Superfund sites, which could be dwarfed by work needed at more than 37,000 hazardous industrial sites and landfills covered by RCRA; cleaning up leaking underground petroleum storage tanks alone could cost $67 billion; and $240 billion needed to clean up DOE's nuclear weapons production facilities). In short the "deductible" cost of cleanup costs paid by taxable entities is likely to be less than $500 billion over 30 years.

[3] *Environmental Cleanup Guidance May Be Out By July, Official Says*, 1993 DAILY TAX REPORT 89 d15 (May 11, 1993)("IRS effectively told taxpayers in the TAM, citing the *Wolfsen* case, that 'you can't wait until Year 10, bunch your deduction and distort income, when this large cost is going to have a beneficial effect over the remaining useful life of the property,' Carrington said.")(Statement of Glenn Carrington, Ass't Chief Counsel, Individual and Tax Accounting); Avakian-Martin, *Does the IRS need to clean up its ruling on cleonup costs?*, 59 TAX NOTES 728, 729 (May 10, 1993)("Lee said the regime properly prevents a taxpayer from deducting costs when a deduction would result in the distortion of income. According to Lee, if a taxpayer is permitted to immediately deduct large extraordinary expenses, such as multimillion dollar

(a) 60 months as Congress usually provides for Government-required environmental, safety-based, etc., capital expenditures such as rapid amortization of pollution control devices[4] or coal mine safety equipment (repealed)[5], which arguably added no value to the taxpayer's property; or as a compromise between hotly litigated extreme all-or-nothing positions as in § 195, **or less likely politically (b) 15 years** as new § 197 provides for *purchased* intangibles. (Such a long period is not needed for revenue neutrality here. Amortization over any period longer than 1 year would generate revenue since cleanup costs appear universally to have been currently deducted or expensed.[6]) Where Congress has provided a current deduction for such Government required capital expenditures, as in the costs of removing barriers to the elderly and the handicapped, it has imposed a low cap ($15,000).[7] **Current deductibility might be appropriate** in the case of **cleanups of waste sites abandoned** or no longer owned by the taxpayer or less likely where the costs exceed the fair market value of the property. I urge this Subcommittee not to stop with cleanup costs, but **address as well the looming question of tax accounting for self-created intangibles in general** also likely to be a big ticket item in time and money soon if not already.

Over the past 15 years, Congress has carved out "self-created intangibles" from its capitalization/amortization reforms, *viz.*, §§ 195, 263A and 197. I understand that at least initially a reason for such carve out was preservation of court victories permitting current deduction of expenditures producing intangibles with future benefit won by special interest taxpayers (e.g., banks) under the "separate asset" rubric (recently and fatefully overruled by the Supreme Court in *INDOPCO*). Roughly 1/4 of the 125 "significant issues" in the IRS Industry Specialization Program involve capitalization/amortization versus expense issues. And capitalization issues account for one Code Section (§263) and a subissue under another (§162 of course) out of the 14 Code Sections identified by GAO as accounting for almost half of the 12,000 appealed issues awaiting resolution in court.[8] While the revenue now involved in such appeals appears to be at the median, I expect that absent Congressional intervention the revenue adjustments set up and ensuing Government and private sector litigation costs will explode as auditing agents apply *INDOPCO* and the capitalization ISPs. I propose an easy fix here too: Congress should **authorize legislative regulations to be formulated by the experience the IRS gains from "rulings" applying capitalization factors which either a code**

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cleanup costs, this would cause a taxpayer to understate income for the year. If large expenditures are incurred every year, or every few years, however, deducting the expenditures would not distort income, Lee maintained. ... Lee argues that cleanup costs do create future benefits because they allow the taxpayer to continue operating its business in future years.").

[4] I.R.C. of 1986 § 169.

[5] I.R.C. of 1954 § 187, repealed Pub. L. 94-455, § 1901(a)(31) [1976].

[6] This is a largely intuitive assumption supported by anecdotal evidence and the fact that the types of amortizable intangibles challenged by the IRS according to the GAO do not appear to encompass capitalized soil remediation costs. *Government Accounting Office Report to the Joint Committee on Taxation, Issues and Policy Proposals regarding Tax Treatment of Intangible Assets* (August 9, 1991)(Appendix I, Taxpayer-Claimed Intangible Assets)(*Electronically reproduced*), 91 TAX NOTES TODAY 169-1 (August 1991). Whether any such revenue should be used to fund a "Member's provision", *see Unofficial Transcript of this Subcommittee's Hearings on September 8, 1993, electronically reproduced* 93 TAX NOTES TODAY 190-32 (September 14, 1993 (Statement of Chair Rangel)("We have had four hearings that focused on these matters. All of those were the revenue losing issues. ... At this time, we will concentrate on those issues that raise revenue. As those of you who are familiar with the committee are aware Chairman Rostenkowski and our committee have a strong commitment to deficit reduction and responsible fiscal policy and in keeping a long tradition any miscellaneous issue that the committee brings up, the member must offset it by appropriate revenue raising items."), as contrasted with a related revenue need like funding DOE cleanups, is another question.

[7] § 190.

[8] *GAO, Report to the Chairman, Subcommittee on Oversight, Recurring Tax Issues Tracked by IRS' Office of Appeals* (GAO/GGD-93-93-101Br May 4, 1993). Fourteen tax code sections account for almost half of the 12,000 appealed issues awaiting resolution in court. Such sections account for more than half of the $100 billion in proposed adjustments being disputed by corporations, partnerships, estates, and individuals. "We found that 14 tax code sections account for about 45 percent -- 5,279 -- of those issues and 57 percent -- $ 56 billion -- of the proposed adjustment amount." GAO also identified the 53 subsections within the 14 code sections that were most frequently appealed or had the highest dollar amount of proposed adjustments. Section 263 mandating capitalization of capital expenditures was one of the 14. Additionally at least one subsection under Section 162, another of the 14 most controversy-generating provisions, involved capitalization. "Data also show that issues related to these 14 code sections accounted for an average of 44 percent of all issues resolved or closed by Appeals during fiscal years 1991 and 1992, 52 percent of the proposed adjustment amounts, and 59 percent of the proposed adjustment amounts sustained by Appeals. Further, 53 subsections within these 14 code sections occur the most frequently or account for the highest dollar amount of proposed adjustments. Each of the 53 subsections accounts for 1 percent or more of the number of open issues and proposed adjustments for all 14 code sections. In addition, data on issues closed in fiscal years 1991 and 1992 show that the 53 subsections represented a significant number of the issues and proposed adjustment amounts." "The 14 code sections also accounted for an average of 52 percent ($ 34 billion) of the $ 67 billion in proposed adjustments and 59 percent ($ 13 billion) of the $ 21 billion in proposed adjustments sustained by Appeals." Capitalization accounted for between $3,047,000 and $3,122,000 of the $56,029,000 in proposed adjustments under the 14 Code sections (and $99,034,000 in total proposed adjustments as of September 30, 1992 or .054% to .056% of the proposed adjustments under the 14 Code sections. Adjustments under §263 alone were the 6th largest. The Service's rate of success on capitalization was comparatively low, but this data reflects the situation prior to *INDOPCO*. Conventional wisdom, confirmed by the trend in ISPs, holds that proposed capitalization adjustments will greatly increase, and I suspect that the IRS' success rate here too will improve greatly *ceteris paribus*.

Section or the legislative history would supply.

I have in mind **capitalization/expense factors** that some Service officials find comfortable and are supported by a few "straws in the winds"-- *Wolfsen Land & Cattle Co. v. Comm'r*;[9] *Cincinnati, New Orleans & Texas Pacific RR v. United States*;[10] and *Southland Royalty Co. v. United States.*[11] The guidepost should be **minimum distortion of income**, promoting "rough justice" rather than exact matching of income and expense. Rough justice is a laudable goal of the IRS 1992 and 1993 "Business Plans". The starting point for minimum distortion of income is that ***business/investment expenses that typically don't provide on the average a benefit much beyond a year*** (say truck tires) ***should be currently deductible*** in the year of purchase. ***Other*** expenditures providing longer benefits should be ***capitalized unless*** (1) they are ***relatively small*** (say hand tools, and professional journals[12]) ***or*** (2) ***regularly recurring*** (say repainting every 3 years or so[13] or steady state advertising[14]) in which case current deduction would also be in order. ***Capitalization*** might also be in order where the benefit was not so long lived but the expenditure was a ***one-time very large outlay***.[15] Once capitalized, the expenditure would be treated as a ***freestanding amortizable intangible***, a deferred charge in financial accounting terms, in the manner of *Wolfsen Land & Cattle*. Administratively and judicially the period of amortization of intangibles has been on a case-by-case basis. Sixty years of experience with depreciation of tangible property has taught that uniform lives is the only administrable way. Congress should provide factors for the Service to employ in determining first in rulings and after refinement later in regulations whether the standard life for classes of such amortizable expenditures would be as short as 60 months or as long as 15 years.

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[9] 72 T.C. 1, 13 (1979)(substantial maintenance-type expense [dredging irrigation canal] restoring subject with indefinite life to original operating condition which need be repeated only every 10 years created "a free-standing intangible asset with an amortizable 10-year life."); *NCNB Corp. v. United States*, 651 F.2d 942, 962-63 (4th Cir. 1981), *vacated and remanded en banc*, 684 F.2d 285 (4th Cir. 1982). The en banc *NCNB* decision in turn was overruled by *INDOPCO, Inc. v. Comm'r*, 112 S. Ct. 1039 (Feb. 26, 1992).

[10] 424 F.2d 563, 572-73 (Ct. Cl. 1970)(expensing small amounts ($500), pursuant to regulatory requirements, did not distort income and burden of capitalizing and amortizing would be great); *accord, Sharon v. Comm'r*, 66 T.C. 515. 527 (1976), *aff'd*, 591 F.2d 1273 (9th Cir. 1978), *cert. denied*, 442 U.S. 941 (1979).

[11] 582 F.2d 604, 618 (Ct. Cl. 1978)(surveys of oil reserves subject to change at anytime [due to shifting of underground oil and water due to nearby drilling and extraction] used in management planning currently deductible; have to be updated every few years so that useful life very uncertain. "In such circumstances, it is not compulsory to amortize such a recurring item over a fixed time-interval. Neither is it appropriate to require capitalization without amortization; such a requirement would clearly distort Southland's income."); *Encyclopaedia Britannica, Inc. v. Comm'r*, 685 F.2d 212, 215 (7th Cir. 1982)(dictum)(Posner, J.)(practical reason for allowing author's recurring expenditures with future benefit to be currently deducted: (a) hard to allocate among specific books; and (2) "allocating these expenditures among the different books is not always necessary to produce the temporal matching of income and expenditures that the Code disiderates, because the taxable income of the author ... who is in a steady state (that is, whose income is neither increasing nor decreasing) will be at least approximately the same whether his costs are expensed or capitalized. Not the same on any given book-- on each book expenses and receipts will be systematically mismatched-- but the same on the average. Under these conditions the benefits of capitalization are unlikely to exceed the accounting and other administrative costs entailed in capitalization.").

[12] Treas. Reg. § 1.162-12(a); see authorities cited in note 10 *supra*.

[13] *Official Gives Update on Series of Guidance on Tax Accounting Issues*, 1993 DAILY TAX REPORT 46 d6 (March 11, 1993)(*Electronically reproduced*)("'As *Wolfsen* pointed out, if [the taxpayer] had cleaned the PCBs every year, it would have been deductible. But if you've waited four or five years, it's not. I gotta draw the line. I've got to say, 'If you do it every second year, you're fine. If you wait six years, it's not.' That's a tough one. I haven't resolved in my mind,'' he said.")(Statement of Glenn Carrington, Ass't Chief Counsel, Individual and Tax Accounting); *accord, Service Ponders Environmental Cleanup Costs; Carrington Uncertain of Outcome*, 93 TAX NOTES TODAY 102-10 (May 12, 1993)("The TAM found that the cleanup expense was not merely incidental because the costs had been accumulating over many years, and that allowing the deduction of the entire cleanup costs in a single year would excessively distort the income in that year. Carrington admitted that the bulk of the cleanup cost would have been deductible had it been incurred as part of a regular maintenance program."). See authorities cited in note 11 *supra*. *See generally* Lee, *Start-Up Costs, Section 195 and Clear Reflection of Income: A Tale of Talismans, Tacked-On Tax Reform, and a Touch of Basics*, 6 VA. TAX REV. 1, 18-21 (1986); Lee, *Doping out the Capitalization Rules After* INDOPCO, 57 TAX NOTES 669, 679-83 (November 2, 1992).

[14] See authorities cited in note 13 *supra*; Lee, *supra* note 13.

[15] *Service Ponders Environmental Cleanup Costs; Carrington Uncertain of Outcome*, 93 TAX NOTES TODAY 102-10 (May 12, 1993)("Carrington said three of the four tests to determine whether a cost is capital are stated in reg. sec. 1.263(a)-1(b): Whether the cost materially increases the value of the property, whether it substantially prolongs the useful life of the property, and whether the costs are incurred to adapt the property to a new and different use. The fourth test is derived from *Wolfsen Land and Cattle Co. v. Comm.*, 72 T.C. 1 (1979), which asks whether the repairs are merely incidental to continued operation or are more of a replacement. The TAM found that the cleanup expense was not merely incidental because the costs had been accumulating over many years, and that allowing the deduction of the entire cleanup costs in a single year would excessively distort the income in that year. Carrington admitted that the bulk of the cleanup cost would have been deductible had it been incurred as part of a regular maintenance program."). Lee, *supra* 57 TAX NOTES at 67-9 (distortion of income should be key to repair but by-and-large repair cases didn't go that way except for *Wolfsen* and *Moss*.)

II. Anatomy of TAM 9315004

The immediate source of the current controversy over the tax accounting treatment of the costs of toxic waste removal is Technical Advice Memorandum 9315004.[16] Years ago the taxpayer there had dumped PCB-contaminated waste, generated by using PCB-laced oil to run its equipment hotter, in pits and trenches on its property out back. About 10 years after the taxpayer's last such dump, the Environmental Protection Agency sued it, PCBs having turned out to be powerful carcinogens. Pursuant to an agreement with the EPA, the taxpayer began to clean up the toxic waste site, spending millions for remediation, transportation, and disposal of the PCB-contaminated soil. The taxpayer expensed the cleanup costs as a repair cost. Upon audit, the Service ruled in TAM 9315004 that the cleanup costs were not incidental repairs and should be capitalized. In a "surprisingly friendly" manner,[17] the TAM permitted the expenditures to be added to the cost of the taxpayer's piping system and deducted over its remaining useful life.[18] Nevertheless, tax lawyers and accountants immediately criticized[19] the IRS' attempt to be "nice", in the words of one Treasury official. Had he capitalized the costs, he would have added them to the cost of the taxpayer's land[20]-- presumably amortizable over the hopefully billions of years remaining in the Earth's useful life. This is where I first came in.

Twenty years ago this coming winter while a practitioner, I first began to describe in articles the then inequity in the start up cost area (capitalization of short-lived or recurring expenditures with no amortization) and how that lead some, but of course not all, tribunals to permit a current deduction of such costs under the "separate asset" doctrine.[21] My article in **The Tax Lawyer** supplied the definition of start-up costs used in the legislative history of § 195.[22] (And now that I know about it, I thank you.) But special interests relying on their judicially sanctioned deductions under the "separate asset" doctrine obtained a carve out for business expansions costs in § 195,[23] a kind of self-created intangible. I collaborated with Professor Bittker on his treatise in the description of that doctrine in the "Capital Expenditures" section of the Business Expenses Chapter of I B. **Bittker, Federal Taxation of Income, Estates and Gifts**,[24] which in turn provided the conceptual foundation for the exclusion of self-created intangibles from § 263A as currently deductible.[25] Similarly Congress just a few months ago carved out self-created intangibles from § 197.

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[16] Avakian-Martin, *Does the IRS need to clean up its ruling on cleanup costs?*, 59 Tax Notes 728 (May 10, 1993).

[17] *ABA Tax Section Panel Wrestles with Impact of INDOPCO*, 93 Tax Notes Today 101-8 (May 11, 1993)(quoting Dan L. Mendelson of Deloitte & Touche).

[18] *Environmental Cleanup Costs Addressed at two ABA Tax Section Meetings*, 93 Tax Notes Today 165-7 (August 6, 1993)("Carrington also said he still finds persuasive the reasoning used in a recent technical advice memorandum concerning the cleanup of PCBs, which relies on the *Wolfsen* case. *He let it slip that in that TAM, the cleanup costs were amortized to the piping system*. That fact was blacked out when the TAM was released.")(Emphasis supplied).

[19] Avakian-Martin, *Does the IRS need to clean up its ruling on cleanup costs?*, 59 Tax Notes 728, 729-30 (May 10, 1993); *Environmental Cleanup Guidance May Be Out By July, Official Says*, 1993 Daily Tax Report 89 d15 (May 11, 1993)(*Electronic Reproduction*); *IRS Says Environmental Remediation Costs Must be Capitalized to Related Asset*, 1993 Daily Tax Report 32 d12 (Friday February 19, 1993)(*Electronic Reproduction*); *IRS Said Seeking Bright-line Tests in Review of Environmental Cleanup TAM*, 1993 Daily Tax Report 102 d6 (May 28, 1993)(*Electronic Reproduction*)("So far, IRS has received about three responses and several telephone calls promising more comments by mid-June, he [Carrington] said. The comments have not given IRS much guidance, but rather have expressed objections to the Service's reasoning in the two TAMs."); Peat Marwick, *supra* 93 Tax Notes Today 148-25; *Akin-Gump Says IRS' Position on Environmental Cleanup Costs Distorts Case Law*, 93 Tax Notes Today 158-18 (July 29, 1993); *Payment of Former Subsidiary's Cleanup Costs Should be Deductible, Attorney Says*, 93 Tax Notes Today 158-32 (July 29, 1993). **[state of law synopsis]**

[20] Avakian-Martin & Carson, *supra* note 1 at 927 ("Kilinskis [Treasury official] also said he disagreed with a conclusion in the PCB TAM. According to Kilinskis, if the costs iconsidered in that TAM should be capitalized, they should be capitalized to the land. The IRS was trying to be 'nice' in reaching the conclusion that costs were not capitalized to the land, he said, and yet the IRS still was criticized.").

[21] Lee, *Pre-Operating Expenses and Section 174: Will Snow Fall?*, 27 Tax Law. 381, 390-401 (1974); *see also* Lee, *A Blend of Old Wines in a New Wineskin: Section 183 and Beyond*, 29 Tax L. Rev. 347, 454-64 (1974).

[22] *Compare* H.R. Rep. No. 1278, 96th Cong., 2d Sess. 9-11 (1980), *with* Lee, *supra* 27 Tax Law. at 384-85; *see generally* Lee, *supra* 6 Va. Tax Rev. at 73-4 and n. 315.

[23] *See* Lee, *supra* 6 Va. Tax Rev. at 79 and n. 337.

[24] I B. Bittker, Federal Income Taxation of Income, Estates and Gifts 20-67 (1st Ed. Warren Gorham & Lamont 1981). My research on capitalization is presented in another form in Lee & Murphy, *Capital Expenditures: A Result in Search of a Rationale*, 15 U. Richmond L. Rev. 473 (1981); *see also* Note, *Distinguishing Between Capital Expenditures and Ordinary expenses: A Proposal for a Universal Standard*, 19 U. Mich. J. of Law Reform 711, 718-30 (1986)(relying heavily on Lee & Murphy for then current doctrine).

[25] The Senate Committee Report stated that § 263A was not intended "to modify present-law principles governing the determination of whether an expenditure results in a separate and distinct asset that has a useful life substantially beyond the tax year. See Treas. Reg. sec. 1.263(a)-1, (a)-2; *Commissioner* v. *Lincoln Savings and Loan*, 403 U.S. 345 (1971). Thus, if the costs of producing an intangible item such as goodwill are deductible under current law, such costs will continue to be deductible under. . . [Section 263A]. The uniform capitalization rule merely will prescribe which costs associated with an asset required to be capitalized must be included in its basis or otherwise capitalized. S. Rep. No. 313, 99 Cong., 2d Sess. 141 and n.38 (1986)(footnote combined with text). The Senate provision reached, however, production of intangible property as well as

The special interests' victories proved ephemeral, just as one witness warned in the § 195 hearings of the possible expansion of capitalization doctrines in the business expansion area.[26] And so it happened, first with business expansion costs at the circuit court level and then with *INDOPCO* at the Supreme Court level as to self-created intangibles in general. Enlightened by Professor Gunn's *The Requirement that a Capital Expenditure Create or Enhance an Asset*[27] discovered in researching for the Bittker Treatise and the case law business expansion cases of the late 1970s and early 1980s and especially *Wolfsen Land & Cattle* and *NCNB I*, I then described in 1986 in the **Virginia Tax Review** (1) the conceptual and policy weaknesses of the "separate asset" doctrine in business expansion and elsewhere; (2) developed the minimum distortion of income model for distinguishing ordinary deductions from capital expenditures, set forth above, along with its case law and policy support; and (3) in particular noted the judicial tendency to reject an income distorting "nothing" under capitalization without adequate capitalization and to choose instead an also income distorting immediate deduction.[28] (I also criticized on a technical basis § 195 far more than with hindsight I would today.[29])

Last year responding to the post-*INDOPCO* practitioner panic, the Service announced that it would address *INDOPCO* in its 1992 Business Plan. I took the opportunity to present my research and minimum distortion of income model in **Tax Notes**,[30] a copy of which I enjoyed the opportunity of handing to Glenn Carrington, IRS Assistant Chief Counsel, Individual and Tax Accounting, at a Virginia Tax Group meeting about 6 weeks before the TAM was issued. Carrington has said that he "heard about the TAM on the way out the door."[31] I believe that the Service provided in the TAM amortization (over the remaining life of the taxpayer's piping system it turns out[32]) in part in order to avoid the all-or-nothing dichotomy (current expense or capitalization without amortization) which was my principal object in writing the article.[33] The key rationale of the TAM, that the cleanup expense was not merely "incidental" because (a) the costs had been accumulating over many years and (b) allowing the deduction of the entire cleanup costs in a single year would excessively distort the income in that year was bottomed on the distortion of income notion of *Wolfsen Land & Cattle*.[34]

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tangible personal property. The earlier Treasury Proposals had excepted (without explanation) from the Uniform Capitalization Rules marketing, selling, and advertising expenses and research and development costs unrelated to particular production activities. 2 **Treasury Report to the President, Tax Reform for Fairness, Simplicity and Economic Growth** 207 (1984); **The President's Tax Proposals to the Congress for Fariness, Growth, and Simplicity** 203 (1985). The Joint Committee Staff had read *Lincoln Savings & Loan* as adopting "a rule of reason" approach to applying section 263, acknowledging the impracticality of requiring that every cost with some conceivable future benefit be capitalized. Joint Comm. Staff, *Tax Proposol: Accounting* 50 (1985)("Case law has generally adopted a rule of reason approach in applying section 263, tacitly acknowledging the impracticality of requiring that every cost with some conceivable future benefit be capitalized. In *Comm'r v. Lincoln Savings & Loan Ass'n*, the U.S. Supreme Court stated that capitalization was required under section 263 only if the expenditure serves 'to create or enhance ... what is essentially a separate and distinct additional asset ... ." The Court beld that 'the presence of an ensuing benefit that may have some future aspect is not controlling,' noting that ' many expenses concededly prospective effect beyond the taxable year.'")(paraphrasing 1 **B. Bittker**, *supra* at 20-67 (1st Ed. Warren Gorham & Lamont 1981). The Conference Report attempted to "clarify" with the ill-proofread statement "that, in addition to the costs specifically excepted from capitalization under the conference agreement (e.g., research and experimental costs, selling, marketing, advertising, and distribution expenses) are not subject to capitalization under the uniform capitalization rules." H.R. Rep. No. 841, 99th Cong., 2d Sess. II-305 (1986). The Bluebook shifted to a new rationale and proves that the parenthetical was meant to close with "experimental costs."[C]onsistent with the long-term contract regulations under section 471, selling, marketing, advertising, and distribution expenses were not intended to be subject to capitalization under these rules. *Joint Committee Staff, General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress; Pub. L. 99-514*, 100th Cong., 1st Sess. 510 (Comm. Prnt 1987). But even more directly, the Conference Bill modified the Senate bill by adding "tangible" as a limitation on *produced* personal property.

[26] *Hearings on H.R. 6883, H.R. 5616, H.R. 5729, H.R. 6039, H.R. 6140, H.R. 6247. H.R. 6824, and H.R. 7009 Before the House Ways & Means Subcomm. on Select Revenue Measures*, 96th Cong., 2d Sess. 110 (1980)(Statement of Gerald Padwe).

[27] 15 **B.C. Indus. & Comm. L. Rev.** 443 (1974).

[28] Lee, *supra* 6 **Va. Tax Rev.** 1-121 (1986).

[29] *Cf.* Mundstock, *Taxation of Business Intangible Capital*, 135 **Penn. L. Rev.** 1179, 1187-92, 1240-43 (1987).

[30] Lee, *supra* 57 **Tax Notes** 669.

[31] *Environmental Cleanup Guidance May Be Out By July, Official Says*, 1993 **Daily Tax Report** 89 d15 (May 11, 1993)(*Electronic Reproduction*). This is why he asked for a notation on the public version of the TAM stating that the memo was being reviewed in connection with an IRS study project on environmental cleanup costs. *Id.*

[32] Avakian-Martin & Carson, *supra* note 1 at 926. I had earlier implied that the Service should pick a number, any number, for period of amortization at least as to small taxpayers. Lee, *supra* 57 **Tax Notes** at 683 and note 124.

[33] *See* Lee, *supra* 57 **Tax Notes** at 670, 677; Avakian-Martin, *supra* note 3 at 730 (quoting John Lee).

[34] *Official Gives Update on Series of Guidance on Tax Accounting Issues*, 1993 **Daily Tax Report** 46 d6 (March 11, 1993)(*Electronic Reproduction*); *accord*, *ABA Tax Section Panel Wrestles with Impact of INDOPCO.* 93 **Tax Notes Today** 101-8 (May 11, 1993); *Service Ponders Environmental Cleanup Costs; Carrington Uncertain of Outcome*, 93 **Tax Notes Today** 102-10 (May 12, 1993); *Environmental Cleanup Guidance May Be Out By July, Official Says*, 1993 **Daily Tax Report** 89 d15 (May 11, 1993)(*Electronic Reproduction*)("IRS effectively told taxpayers in the TAM, citing the *Wolfsen* case, that 'you can't

III. Approaches under IRS/Treasury Consideration

Treasury and Service officials are debating "the form the guidance [on *INDOPCO*] should take -- whether rulings, regulations, or legislation -- and what position the government ought to adopt with respect to cleanup costs -- whether deductible in all cases, capitalizable with no recovery, or capitalize it with some sort of recovery."[35] After repeatedly requesting practitioner guidance and receiving about 25 written comments, Treasury officials have outlined several practitioner suggestions under consideration[36]: (1) a series of factual rulings, (2) capitalization of almost all cleanup costs with amortization over a fixed period such as 60 months, and (3) following Generally Accepted Accounting Principles. The Service also has indicated circumstances in which the costs of soil remediation or other expenditures should be currently deductible: (a) prior abandonment of the property;[37] and (b) where the future benefit occurs at some immeasurable point in the future.[38]

1. Factual Rulings to establish "Bright Line" Rules.

One approach is to issue revenue rulings dealing with typical fact patterns establishing bright-line tests.[39] This lends itself best to current deduction situations such as advertising or garden variety repairs. While a few such rulings might account for 75% or so of the cases, they are less likely to reach the grey areas, particularly where capitalization and amortization are appropriate. An underlying problem here is that published Revenue Rulings are generally thought to reflect the Service's understanding of primary authorities, such as Code, Regulations and cases. The above "straws in the wind" are just that-- a few probably destined to be leading cases among a sea of conflicting and often directionless cases. Repair precedent in particular is creaky, with the main exceptions of (a) *Moss v. Comm'r*,[40] where the Ninth Circuit endorsed currently deducting replacements (repainting and repapering) concentrated in a single year of a 3 to 5 year cycle consistent with *Southland Royalty*, and (b) *Wolfsen Land & Cattle*.

2. Fixed Amortization Period.

Practitioners have recommended and the Service is studying establishment of an amortization

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wait until Year 10, bunch your deduction and distort income, when this large cost is going to have a beneficial effect over the remaining useful life of the property,' Carrington said.").

[35] *Treasury Official Sees Environmental Clean-up Guidance this Year as Warranted*, 1993 DAILY TAX REPORT 88 d23 (May 10, 1993)(*Electronically Reproduced*)("[A]n administrative solution may not be ideal, Kilinskis said. "Frankly, I think the better solution is a legislative solution. We at Treasury would like to work with you to come up with a solution that you can live with and we can live with and that gets to the right answer," Kilinskis said.").

[36] *IRS Said Seeking Bright-line Tests in Review of Environmental Cleanup TAM*, 1993 DAILY TAX REPORT 102 d6 (May 28, 1993)(*Electronic Reproduction*); Avakian-Martin & Carson, *supra* note 1 at 926.

[37] 1993 DAILY TAX REPORT 89 d15, *supra* (*electronically reproduced*)("Asked whether the result in the TAM would have been different if the taxpayer involved had abandoned the property, Carrington said perhaps, because no future income would exist for matching the expense. 'People have argued that the land fill cases are deductible because more or less when you do this land fill, you are closing the door,' he said."); *Environmental Cleanup Costs Addressed at two ABA Tax Section Meetings*, 93 TAX NOTES TODAY 165-7 (August 6, 1993)("Carrington said a few bright-line tests, suggested by commentators, are stirring up interest among government officials. He said one such proposal would permit a deduction, rather than capitalization, of the cost of cleaning up property whenever the taxpayer does not own the land. Another proposal generating interest would permit a deduction for cleanup costs when a taxpayer owns the land but stops production on the land. A third bright-line test, said Carrington, would permit a deduction for remediation costs to the extent that the costs exceed the value of the land. He added that the issues are far from resolved within the government.").

[38] *IRS to Issue Additional Technical Advice on Environmental Cleanup, Official Says*, 1993 DAILY TAX REPORT 152 d4 (August 10, 1993)(*Electronic Reproduction*)(citing Rev. Rul. 92-80, 1992-1 C.B. 57. *Cf. NCNB I*, 651 F.2d at 961-62 ("[T]here is a residuum of current expenditures which will have some future bnefit but which 'cannot, as a practical matter, be associated with any other period' and allocation of which 'either on the basis of association with revenue or among several accounting periods is considered to serve no useful purpose.'")(Footnotes omitted)(relying on GAAP).

[39] *Service Ponders Environmental Cleanup Costs; Carrington Uncertain of Outcome*, 93 TAX NOTES TODAY 102-10 (May 12, 1993); *IRS Environmental Cleanup Guidance May Be Out By July, Official Says*, 1993 DAILY TAX REPORT 89 d15 (May 11, 1993)(*Electronically reproduced*); *Treasury Official Sees Environmental Clean-up Guidance this Year as Warranted*, 1993 DAILY TAX REPORT 88 d23 (May 10, 1993)(*Electronically Reproduced*)("If we can decide that there are three, four, or five fact patterns that cover 75 or 85 percent of all the liabilities that are out there, then I think it's worth taking a stab and analyzing those situations and coming up with an answer. I am not against taxpayers deducting environmental liabilities. All I'm saying is that it's an area that we need to do more work, carve through all these rules, and come up with what we agree is the right answer," he [Kilinskis] said."); *IRS to Issue Additional Technical Advice on Environmental Cleanup, Official Says*, 1993 DAILY TAX REPORT 152 d4 (August 10. 1993)(*Electronically reproduced*)("Service is closest to issuing guidance for ordinary repair costs"); *Service to Issue Guidance on Deductions for Environmental Cleanup, Says Carrington*, 93 TAX NOTES TODAY 167-6 (August 11, 1993)(same).

[40] 831 F.2d 833, 842 (9th Cir. 1987).

period, such as 5 or 10 years, and writing off the cleanup expenses over that period.[41] The Service recently took a similar approach as to the cost of package design.[42] "The question here is whether the industry will sign on to such an approach."[43] With a revenue procedure or ruling format the Service would not be able to require all taxpayers with toxic waste cleanup costs to capitalize and amortize. The likely result, following Treasury's reasoning as to § 197, would be that taxpayers with really questionable deductions would choose capitalization and amortization while the stronger cases would continue to deduct currently. Therefore Congressionally mandated capitalization with amortization is advisable as in § 197 and the 1984 version of § 195.

Additionally some have questioned whether the Service can just pick an amortization period without statutory authority.[44] While it has done so in the past,[45] absence of a statutory mandate surely would lead to many taxpayers ignoring the amortization/certainty option. This was the case with the original version of § 195.

3. GAAP.

Another approach is to follow "generally accepted accounting principles" for the tax treatment of cleanup expenditures.[46] But this might not be popular among those seeking current deductions for cleanup costs since GAAP may require capitalization in many cases.[47] The Fourth Circuit panel decision in *NCNB I* offers a glimpse into the dangers of trying to resolve capitalization/amortization versus expensing by GAAP. There the panel adopted the GAAP hierarchy of expense recognition in descending order of preference: (1) by cause and effect with revenue generated, (2) by systematic rationale, and (3) year of expenditure.[48] This lead to an impermissible allocation between current and future years on actual use, where as amortization of an intangible property properly is straightline for the number of years in the property's useful life.

4. Abandonment

A few bright-line tests, suggested by commentators, are stirring up interest among government officials but are far from resolved. Commentators have suggested that abandonment of the toxic waste property (or whenever the taxpayer no longer owns the contaminated real estate) should give rise to ordinary deduction on the grounds that no future income could exist for matching the expense.[49] A similar proposal would permit a current deduction for the cost of cleaning up property whenever a taxpayer owns the land but has stopped production on the land. A third bright-line test would permit a deduction for remediation costs to the extent that the costs exceed the value of the land.[50]

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[41] *IRS Said Seeking Bright-line Tests in Review of Environmental Cleanup TAM*, 1993 Daily Tax Report 102 d6 (May 28, 1993)(*Electronic Reproduction*);

[42] Rev. Proc. 90-63, 1990-2 C.B. 664, offers taxpayers three alternative methods of accounting for package design costs; (1) capitalization, (2) design- by-design capitalization and 60-month amortization, and (3) pool-of-cost capitalization and 48-month amortization. *See Environmental Cleanup Costs Addressed at two ABA Tax Section Meetings*, 93 Tax Notes Today 165-7 (August 6, 1993)(Statement of Carrington)("IRS is concerned that many taxpayers would not buy into that system, he said. 'It may help people in the very gray area and other people would continue to do what they're doing and it won't be useful, ... [Carrington] said. Asked whether IRS believes it has regulatory authority to 'arbitrarily' require capitalization over a fixed period, such as five years or 10 years, Carrington responded, 'It would be arbitrary, but we've done arbitrary--reasonably arbitrary--things in the past.'"). *See* note 32 *supra.*

[43] *Service Ponders Environmental Cleanup Costs; Carrington Uncertain of Outcome*, 93 Tax Notes Today 102-10 (May 12, 1993).

[44] *IRS Environmental Cleanup Guidance May Be Out By July, Official Says*, 1993 Daily Tax Report 89 d15 (May 11, 1993)(*Electronically reproduced*).

[45] *See* note 42 *supra.*

[46] *IRS Said Seeking Bright-line Tests in Review of Environmental Cleanup TAM*, 1993 Daily Tax Report 102 d6 (Friday May 28, 1993)(*Electronic Reproduction*); *Environmental Cleanup Costs Addressed at two ABA Tax Section Meetings*, 93 Tax Notes Today 165-7 (August 6, 1993) ("Third, IRS is exploring the adoption of the presumption that taxpayers would capitalize the expenditures if they already would capitalize them under the rules under generally accepted accounting principles, according to Carrington. 'We hear that agents are raising *Indopco* and long term benefit and really causing problems out there and maybe we should look and see what you're doing and if you're saying it's capitalized and you're following the GAAP rules maybe that's what we should use. Maybe that's a good bright line test,' he said. Carrington acknowledged that normally the GAAP rules do not control for purposes of the tax code, but that IRS would be looking at those rules to see whether they 'are somewhat in line with what we think the law is.'").

[47] *Environmental Cleanup Costs Addressed at two ABA Tax Section Meetings*, 93 Tax Notes Today 165-7 (August 6, 1993)

[48] 651 F.2d at 952-3, 962-63. For a criticism of this notion see Lee, *supra* 6 Va. Tax Rev. at 20-4, 38-41.

[49] *Environmental Cleanup Guidance May Be Out By July, Official Says*, 1993 Daily Tax Report 89 d15 (May 11, 1993)(*Electronically reproduced*)("'People have argued that the land fill cases are deductible because more or less when you do this land fill, you are closing the door,' he [Carrington] said."). Two of the 5 possible factors looked at early by the Service ("(2) whether the property to which the cost relates is owned by the taxpayer; (3) whether the property to which the expenditure relates will generate future income", *see* Avakian-Martin, *Does the IRS need to clean up its ruling on cleanup costs?*, 59 Tax Notes 728 (May 10, 1993)), appear related to this notion. Those five factors "may or may not be relevant in deciding these issues," he

The policy for the abandonment exception is sound and consistent with precedent allowing an ordinary deduction for an abandonment loss. Property sold but for whose cleanup costs the taxpayer is liable (because in the chain of title or did the toxin dumping) fits the policy as well but not the current case law. Such cost would be associated with the sale of the property under both the origin of the claim doctrine for capitalization and if the sale was in a prior year (year 1) under the *Arrowsmith* doctrine.[51] Whether the loss is a capital loss or an ordinary loss under conventional analysis turns first on whether the contaminated property was § 1231 property. If so, as usually will be the case, then under the view that *Arrowsmith* provides a fictional sale in year 2, the loss is a § 1231 usually ordinary loss but capital loss recapture could apply under the 5-year lookback. In my view *Arrowsmith* more matches the year 2 character with the year 1 character as the year 1 transaction is backed out by a balancing adjustment.[52] So if the year 1 sale yielded a § 1231 capital gain, at least that gain would be reversed by a capital loss in year 2. Add the fact that a § 1231 gain has not been taxed at favorable rates to corporate taxpayers since 1986 but capital losses are treated harshly indeed, and none of this makes much sense as a matter of policy or in general. Some of these results could perhaps by obviated by treating the cleanup cost itself as an intangible asset (*Wolfsen Land & Cattle*) which then could amortized over the appropriate period (even as short as 1 year if recurring but that would not be the case here). Congressional dictation of the answer on this point is essential.

Cost over value differs. The cost still may so large that current deduction would distort the taxpayer's income and may yield future benefits in continuation of operations without shutdown by the EPA or whomever. Again the origin of the claim doctrine would seemingly require capitalization adding the cost to the non-amortizable land but treatment as a freestanding amortizable intangible might avoid this. Additionally, the Congressional pattern has been to provide 60-month amortization for mandated capital expenditures arguably providing no direct additional value.

At one time Service considered taking into account whether the property was already contaminated at purchase. Under conventional repair doctrine, making an otherwise deductible repair must be capitalized as an acquisition cost where the taxpayer acquired the property knowing of the defect. From the point of future benefit and income distorting amounts, the pre-existence of contamination is irrelevant. But it would be a factor in any analysis trying to allocate the cleanup costs between the taxpayer's past operations and future operations since such pre-existing pollution could hardly be related to past operations.

IV. Proposed Solutions to Soil Remediation Costs

As a general prospective rule, by statute all substantial soil remediation costs should capitalized and then amortized over 60-months. Current deduction should be provided by statute for such costs incurred as to abandoned property, etc., as this Subcommittee deems appropriate.

V. Proposed Solution to Capital Expenditure/Expense/Amortize of Self-Created Intangibles

The welcome new spirit of cooperation between the Service and taxpayers and of effecting "rough justice"-- manifested by the IRS National Office developments such as the annual "Business Plan", release of ISPs, substantive participation by IRS and Treasury Officials in public (tax) conferences, and yes TAM 9315004-- as well as the notion of "Re-Inventing Government in the air indicates that the time is ripe for Congress to try a different approach to rule making in an area that affects all business taxpayers big and small. Congress should establish the policies that capitalization is to effect, e.g., minimum distortion of income which would be illustrated in the legislative history to an amendment of § 263 authorizing legislative regulations by factors such as recurring, smallness, or whatever Congress deems appropriate. They could largely be extracted from the cases cited herein. So far this is exactly what Congress did in §385. To avoid the fate and probably complexities of the late

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said. *IRS Environmental Cleanup Guidance May Be Out By July, Official Says*, 1993 DAILY TAX REPORT 89 d15 (May 11, 1993); Avakian-Martin & Carson, *ABA Tax Section Meeting: Environmental Cleanup Issue: A Repeating Theme at ABA Meeting*, 60 TAX NOTES 925, 926 (August 16, 1993).

[50] *Environmental Cleanup Costs Addressed at two ABA Tax Section Meetings*, 93 TAX NOTES TODAY 165-7 (August 6, 1993)(Statement of Carrington).

[51] *See* Lee & Murphy, *supra* note 24 at 484-509.

[52] Lee & Bader, *Contingent Income Items and Cost Basis Corporate Acquisitions: Correlative Adjustments and Clearer Reflection of Income*, 12 J. CORP'N L. 137, 212-13 (1987).

§ 385 regulations, I propose a model of the Service first implementing the Congressionally sanctioned policies by issuing rulings (PLRs, TAMs, and then "published" rulings), which then would evolve into regulations employing a "structured discretionary justice" approach. All of this probably could be accomplished in a shorter time than the § 385 experience.

Detailed regulations promulgated by an administrative agency, here Treasury and the Service, increase the principled discretion of the agency as a decision maker, according to Professor Davis' landmark book "DISCRETIONARY JUSTICE – A PRELIMINARY INQUIRY" and subsequent administrative law scholarship.[53] Moreover, Professor Davis posits that such detailed rules channeling agency exercise of discretion can develop from first considering one concrete problem at a time, announcing the hypothetical cases as rulings and refraining from generalizing; then fashioning generalized principles or standards from this experience; and finally formulating regulations to implement the standard in the form of structured discretion.[54] The issue of general versus particularized statute and whether to implement through Treasury or Service discretion has been before Congress many times before, particularly in 1921/1923[55] and 1934.[56] Similarly tax theoreticians, including in the late 50's and

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[53] DAVIS, DISCRETIONARY JUSTICE, A PRELIMINARY INQUIRY, 103 (LSU Press 1969); *see also* MASHAW, BUREAUCRATIC JUSTICE, MANAGING SOCIAL DISABILITY CLAIMS 103-22 (Yale Univ. Press 1983); Lee, *Structured Discretionary Justice Under Section 355*, 44 TAX NOTES 1029, 1030 (August 28, 1989). An agency issuing regulations (rule making) setting forth specific factors to be used in balancing tests implementing the desired standards and policies can implement standards effectively while maintaining the desirable bureaucrat's discretionary judgement in application. *Id.* at 1032.

[54] Lee, *supra* note 53 at 1032.

[55] *See* 1921 Confidential Senate *Hearings*, *supra* at 5 (Statement of Dr. T. S. Adams, Tax Advisor, Treasury Dept.; drafting goal of "a rather simple tax law that the average man can understand"). *See Hearings on H. R. 6715 before the Sen. Comm. on Finance*, 68th Cong., 1st Sess. 7, 57 (1924)(statement of A. W. Gregg, Special Ass't to Treasury, "complications come primarily from a complicated policy," including reorganizations. "[T]he bill will cover a given case definitely and certainly. Under the existing law there are hundreds of cases where nobody knows the effect of the transaction upon the tax. This law is definite enough so that the taxpayers will be able to tell the effect of a given transaction . . .").

[56] *See Statement of the Acting Secretary of Treasury Regarding the Preliminary Report of a Subcommittee* 9-10 (1934):

> The reorganization provisions are, as the subcommittee states, perhaps the most complicated and difficult to understand of any sections of the law. In addition to their complexity, they are open to the serious objection of being overspecific. When they were adopted in 1924, the draftsmen attempted to state in minute detail exactly how each step of a reorganization should be treated for tax purposes. Although this method had the apparent advantage of enabling taxpayers and their lawyers to determine in advance exactly how proposed transactions would be taxed, it had the disadvantage of leaving the Department no leeway in the administration of the law. Consequently, astute lawyers could and did arrange what were really sales to take the technical from of a reorganization within the statutory definition, with resultant loss of revenue. The Treasury has fought a number of these cases through the courts, with results on the whole favorable. The courts have attempted to work out the general principles underlying the statute, and to interpret the specific sections in such a way as to carry out the general plan and to prevent avoidance.
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> In the light of this experience of 10 years, the Treasury has come to the conclusion that the present provisions should be completely redrafted. The purpose should be to express in the statute as simply as possible the general plan for dealing with these transactions, leaving to the Department as in other cases the power to make rules and regulations to carry out the congressional intent. Congress has previously dealt with the subject of affiliated corporations in this way, with excellent results so far. In the cases of complicated subjects of this kind, it is almost impossible to foresee all the ingenious devices which lawyers will invent, and to provide against them expressly in the statute. The more effective plan is to place the responsibility squarely upon the Department administering the law from day to day. It can readily amend its regulations to cover new situations as they arise.
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> The question then is whether the present provisions should be scrapped in their entirety before a satisfactory substitute can be framed. The committee should carefully consider several problems before this is done. In the first place, depreciation and depletion are now calculated for thousands of corporations on the basis of costs figured under the present reorganization provisions. These sections in general required the new corporation to take the same cost as the old for depreciation and depletion purposes, even though the assets had greatly increased in value. If the provisions were abolished outright, many of these taxpayers could and would claim largely increased amounts of depreciation and depletion, with resultant loss of revenue. In the second place, reorganizations today are generally being carried out in order to revise the capital structures of unsuccessful or insolvent enterprises. The immediate result of abolishing the reorganization provisions would be to permit the thousands of bondholders and stockholders of such organizations to establish losses, even though they obtain and retain securities in a new enterprise which is substantially the same as their original investment. Even though it be required that such losses can only be deducted from capital gains, a wide door will be opened to reduction of tax liability. Finally, there are many legitimate reorganizations in which the present general policy of the law is sound ... ..
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> ......
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> For these reasons, the Treasury believes that it would be unwise to eliminate completely the exchange and reorganization provisions at this time. The Department is now working upon a substitute for the present provisions, which will be completed as soon as possible. The task is not easy, on account of the complexity of the transactions involved. Until the various alternatives can be carefully studied, and a plan worked out which will work fairly and safeguard the revenues, it does not appear advisable to abolish completely the present statutory plan. The Department believes, as stated, that the proposal would not only yield no additional revenue, but would result in a net loss.

By the time of the House Ways and Means Committee Hearings Dr. Roswell Magill had been appointed Assistent Secretary of Treasury. Unfortunately in the 1934 House Hearings on Revenue Revision Dr. Rosewell Magill, representing Treasury, in fact failed to argue forcefully for a "legislative" regulations approach, of which the 1933 Ways & Means Subcommittee Chairman Hill, D-Wash., was skeptical anyway. Treasury instead argued for the status quo, as did public witnesses. *Hearings on Revenue Revision 1934 before the House Ways & Means Comm.*, 73d Cong., 2d Sess. 74-7 (Magill responded to whether Treasury had early 60's Harvard's Professors Brown and Surrey, have debated for some time the advantages of generalized tax statutes, i.e., standards, versus detailed or rule-oriented tax statutes.[57] The recent majority of students of taxation follow the Surrey school of a more or less generalized tax statute implemented and amplified, however, through undisputably detailed Treasury regulations, in large part due to the greater flexibility in amending regulations than statutes in light of developing administrative and judicial experience under the statute.[58] Notwithstanding conventional wisdom, the case for agency discretion was never fully made nor the notion of general statute with detailed regulations ever fairly tested. This Subcommittee in this perhaps inauspicious context (the witnesses' tone is reminiscent of the 1936 Ways & Means Hearings on the ill-fated Undistributed Profits Tax) has the opportunity to start a grand experiment. Turn the Treasury and Service loose, with guidance. I trust they will effect rough justice and substantially cut down on tax controversies in this most controversial of areas.

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so re-drafted the regulations that "[w]e have not been able to, because the provisions with respect to reorganizations are so detailed and specific there is no way for us to interpret them away from their obvious meaning. ... "); 287; 290-91 (capital structures plus past legisl. history); 323 (fairness in bituminous industry)(1933).

> MR. HILL. ... Do you believe it is possible to write a provision in the statute permitting tax-free reorganizations without opening the door to reorganizations purely for tax exemption purposes?
>
> MR. MAGILL. It undoubtedly would be a very difficult job, because, as I do not need to tell you, reorganizations are the most complicated transactions anybody has to deal with.
>
> To write a provision to catch the ones you want to catch and perhaps to let others through that are legitimate is quite a job. I think that was probably as well done in 1924 as it could have been done. A great deal of thought was spent on that, and it was done very carefully.
>
> MR. VINSON. We are 9 years past 1924, and we are able to see many doors and outlets through which taxpayers go to avoid taxes, and it was our purpose to close some of those doors.

Id. The House Ways and Means Committee permitted only statutory mergers.

[57] Brown, *An Approach to Subchapter C*, 3 TAX REVISION COMPENDIUM 1619, 1619-20 (1960)(detailed tax statutes lead to deficiencies and anomalies appearing which requires even more intricate elaborations of pattern; fundamental source is attempt to eliminate the necessity for responsible administration); Surrey, *Complexity and the Internal Revenue Code: The Problem and Management of Tax Detail*, 34 LAW & CONTEMPORARY PROBS. 695-702, 703-07 (1969)(debate between generalized and particularized tax statutes; concludes ideal is generalized statute with detailed regulations). Interestingly, the Tax Reform Act of 1969, which was Surrey's brainchild, *see* Lee, *supra* 8 VA. TAX REV. at 132 n. 346, rarely took this tack (Section 385 constitutes a conspicuous exception).

[58] E.g., *Complexity and the Income Tax*, *supra* note 57 at 348-51. *But see* E. Cohen, *Remarks*, 26 NAT'L TAX J. 311, 311-12 (1974). For an excellent, brief discussion of the recent pattern, including the "worst of all worlds . . . extremely detailed statutes . . . with broad grants of regulatory authority . . . ", *see* Evans, *The Condition of the Tax Legislative Process*, 39 TAX NOTES 1581, 1590 (June 27, 1988).

Chairman RANGEL. Professor Tucker.

Mr. TUCKER. When Professor Lee talks about the academic writers all agree——

Chairman RANGEL. You are a professor, too.

Mr. TUCKER. I am a professor at both Georgetown—I am not a full time professor. I also practice law.

Chairman RANGEL. There is a difference.

Mr. TUCKER. It may or may not make a difference. I have been teaching the income taxation, real estate transactions since 1970, at George Washington Law School and since 1990, at Georgetown Law School.

Chairman RANGEL. Do you agree with Professor Lee?

Mr. TUCKER. I also have a two-volume set on the Federal taxation of real estate transactions, published by Cartboard and Callahan, so I think I do have some credentials, OK? I have told them this for years, and I think that—Howard Levine is also an adjunct professor at Georgetown, and I think we have equal credentials with Professor Lee.

I would argue that that test is not too broad. It has been limited over the years by Congress in the deferred like-kind exchange area, foreign property for domestic property and the like, and I think that was too broad a statement, unfortunately.

Mr. LEVINE. I disagree with Professor Lee. I do not think the question of the continued liberalism of the courts is in issue these days. The IRS published regulations a couple years ago. It was a 1984 amendment. All of this was done to address a liberal trend in the courts.

I don't think there is that concern now. I don't think there is a concern on the part of the IRS. I don't think there is a concern on the part of Treasury. Obviously, there is not. Treasury is opposed to any change because there is no need, there is no necessity to make this change. So I do not agree with the professor.

Chairman RANGEL. Well, I think Mr. Lee makes a lot of sense. I mean full Professor Lee makes a lot of sense. I don't know how this would—how the courts would possibly handle a narrower version. It is a factual question; you leave it up to the court. I don't see how we can do that.

Mr. LEE. Chairman Rangel, I was not suggesting that we leave it to the courts. I was suggesting that you all, in determining what similar, related in service as used for real estate, for example, should mean, you all should decide it should focus on return, risk, and management activities or whatever other factors you want, and then not leave it to the courts but leave it to the service and then begin with that as a base for ultimately having legislative regs.

They first issue rulings as the facts come up, build up a little experience, then they build it into regs. The problem is right now that under 1033 or even the soil remediation, any of this, you cannot police it with substantial authority. There is enough stuff out there that on a one out of three, any of us can find authority on any side, and therefore people will take any side, and so what we need is more direction and then let the service do what it does best, but with authority.

When I say direction, I am really almost saying authority, and that is what I am really requesting. No, we don't want more litigation. You look at those cases, they haven't done it well.

Mr. LEVINE. Mr. Chairman, if this change is made, I think all that would be done here is substituting this situation for the amortization of intangibles situation in terms of the amount of litigation that would progress, the amount of the uncertainty, and that cannot be in anyone's interests.

Chairman RANGEL. Well, Mr. Jacobs, any questions?

Let me thank the board. On something as important as this, the committee will not be moving until we get the professors back in to help us out on this.

We will break for 10 minutes and then Chairman Jacobs will start with the fourth panel.

Is Mr. Fay here?

Thank you.

[Recess.]

Mr. JACOBS [presiding]. The next panel is already in place.

Does anybody want your names called for the record or shall we just proceed? Let's do that. In the order in which you are listed. Maybe you don't have the listing. So let's start with Mr. Fay.

STATEMENT OF KEVIN J. FAY, EXECUTIVE DIRECTOR, ALLIANCE FOR RESPONSIBLE CFC POLICY

Mr. FAY. Thank you, Mr. Chairman.

Mr. Chairman, my name is Kevin Fay, and I am executive director of the Alliance for Responsible CFC Policy. I would like to note for the record that I am not a professor, but my mother loves me just the same, adjunct or otherwise. I will submit my bona fides later, though, if you like.

On behalf of the alliance I am presenting testimony today in opposition to the addition of HCFCs to the existing list of taxable ozone-depleting compounds.

The alliance is a coalition of over 200 companies and industries and associations that produce CFCs, HCFCs and HFCs and products that use these chemicals. I have attached a list. The alliance has been instrumental in promoting an effective global approach to ozone protection, while minimizing costly and ineffective regulations on user industries. We have worked closely with Congress and EPA in developing technically and economically feasible Clean Air Act regulations.

I will summarize our three key points in opposition to this proposal. First of all, HCFCs are to be cautiously encouraged in their utilization. Both the Montreal Protocol and the Clean Air Act Amendments of 1990 encourage the rapid phaseout of CFCs. There is no disagreement among the international community, the Federal Government, and industry that HCFCs are necessary transitional compounds which must be made available in order to achieve this rapid phaseout of CFCs. In fact, the international and domestic policy supports the continued production of HCFCs for these applications on timetables ranging from 2003 to 2030, nearly 40 years.

EPA has worked on approving HCFCs, and in advocating their use has benefited society and industry in this transition. Clean Air

Act Section 612 requires that EPA identify substitutes that, "reduce the overall risk to human health and environment."

The SNAP program, Significant New Alternatives Policy, identifies HCFCs as acceptable substitutes for CFC compounds in a variety of applications, including use as refrigerants in air conditioning and refrigeration, and the manufacture of energy-efficient building insulation. I have attached the EPA SNAP list of approved uses.

As you can see from this list, HCFCs in numerous instances meet the congressionally mandated standard of reducing overall risk to human health and the environment. Subjecting these compounds to the same tax which is applied to the ozone-depleting CFCs which they replace sends a message inconsistent with the message EPA is sending under SNAP.

We urge the Congress to coordinate with EPA to promote the use of HCFCs in these applications where they are beneficial in order to avoid unnecessary confusion as to their impact on individuals and to the environment.

Considerable investment has been made with the Government's encouragement in HCFCs and alternative technologies employing them. A tax on these compounds could slow down the shift to these CFC alternatives and could potentially harm many companies, both large and small, which have relied on international and domestic government acceptance of these compounds in many industrial applications. This is somewhat akin to the Government asking the farmers of America to solve the world hunger problem and then putting an excise tax on their crops.

HCFCs are essential for the preservation of food, medicines, indoor climate control, and energy efficiency. In fact, an HCFC tax could threaten the viability of the entire rigid foam insulation industry which supplies the most energy-efficient building insulation material available today. This material is critical to the United States achieving its goals under the climate change action plan which we agreed to last year in the treaty at Rio.

These industries in the United States have just undertaken the tremendous task of making the rapid transition from CFCs and implementing these alternatives, but they also understand the importance of identifying alternatives to the HCFC compounds and in preparing for their ultimate phaseout by the year 2030, but these industries need to focus their resources on the development of those alternatives, not on paying punitive taxes.

The second key point, HCFCs are environmentally beneficial, as is evidenced by EPA's own SNAP program decisions. At the recent Copenhagen meeting of the parties to the Montreal Protocol, UNEP science advisor Robert Watson stated, "It is feasible to phase out CFCs between 1995 and 1997, assuming an aggressive recycle and retrofit policy, and with HCFC substitution for some important uses. HCFCs will be required for a period of time for a number of applications, in particular refrigeration, air conditioning, heat pumps and insulating foams." In other words, the accelerated phaseout schedule for CFCs is predicated on HCFC utilization.

The third key point is that HCFC tax is going to be an ineffective revenue source. The CFC tax which was adopted in 1989 is likely to only raise approximately half of what was projected to be raised when it was originally proposed and adopted. We think that the HCFC tax will be equally speculative.

Industry has already identified many technologies that do not use fluorocarbon-based products. At least 50 to 75 percent of the CFC substitute market is expected to be replaced by conservation practices and so-called not-in-kind substitution. Projected HCFC utilization is less than 15 to 20 percent of the old CFC market, and that projection is nearly 50 percent less than a similar projection just a couple of years ago, so clearly the HCFC tax is not likely to raise the revenue that it is projected to raise currently.

In sum, we ask the subcommittee to reject the addition of HCFCs to the list of taxable ozone-depleting compounds. Congress clearly delineated a difference between class I compounds and class II compounds in Clean Air. We think that delineation should be maintained in the tax policy as well.

The ozone protection effort is succeeding because of the extraordinary cooperation between government and industry. We will continue to work with the Congress and EPA in minimizing confusion over the acceptability of these alternatives, but this proposed tax change is inconsistent with these objectives. We think it is bad environmental policy and is bad tax policy.

Thank you.

[The prepared statement and attachments follow. For attachment 2, please see Federal Register, Vol. 58, No. 90, dated Wednesday, May 12, 1993, pp. 28160–28187.]

TESTIMONY OF KEVIN FAY
EXECUTIVE DIRECTOR, ALLIANCE FOR RESPONSIBLE CFC POLICY

My name is Kevin Fay and I am Executive Director of the Alliance for Responsible CFC Policy. On behalf of the Alliance, I am presenting testimony opposing the addition of HCFCs to the existing list of taxable ozone-depleting chemicals.

The Alliance is a coalition of over two hundred companies that produce chlorofluorocarbons (CFCs), hydrochlorofluorocarbons (HCFCs), and hydrofluorocarbons (HFCs), and manufacture products that use these chemicals. (See Attachment 1). The industry sectors which comprise the Alliance include chemical production; air conditioning and refrigeration; refrigerant recovery, recycling, and reclamation; foam insulation; foam packaging; electronics; motor vehicle; and medical products. The Alliance was organized in 1980 to coordinate industry participation in development of reasonable international and federal government policies on the regulation of CFCs and their alternatives, and protection of the ozone layer.

The Alliance has been instrumental in representing industry's voice on the international, federal, state, and local levels of government, and in promoting an effective global approach to ozone protection, while minimizing costly and ineffective regulations on user industries. We have worked closely with Congress and the Environmental Protection Agency in developing technically and economically feasible Clean Air Act requirements.

HCFCs ARE TO BE ENCOURAGED

Both the Montreal Protocol and the Clean Air Act Amendments of 1990 encourage the rapid phaseout of CFCs. There is no disagreement among the international community, the federal government, and industry that HCFCs are necessary transitional compounds which must be made available in order to achieve a rapid and successful CFC phaseout. The Alliance recognizes the minimal ozone depletion potential of the HCFCs; and industry is working to identify alternatives for them. Nevertheless, international and domestic policy support the continued production of HCFCs for certain applications on timetables ranging from 2003 through 2030. There is no scientific or environmental justification to discourage HCFC use prior to these dates since they offer a balance of safety, performance, economic, and environmental benefits.

The imposition of a tax on these compounds by the Congress would impede efforts to encourage environmentally responsible use of HCFCs. EPA's work in approving HCFCs and in advocating their use has benefited industry and society in the transition away from CFCs. Clean Air Act Section 612 requires that EPA identify substitutes that "reduce the overall risk to human health and the environment." EPA's Significant New Alternatives Policy (SNAP) Program, a requirement of the Clean Air Act Amendments of 1990, identifies HCFCs as acceptable substitutes for CFCs in a variety of applications, including use as refrigerants in air conditioning and refrigeration, and in the manufacture of energy efficient building insulation. (See Attachment 2).

Subjecting the HCFCs to the same tax which is applied to the ozone-depleting CFCs which they replace sends a message inconsistent with the message EPA is sending under SNAP. We urge the Congress to coordinate with EPA to promote the use of HCFCs in applications where they are beneficial, to avoid unnecessary confusion as to their impact on individuals and the environment, and to remove barriers which may discourage industries from using HCFCs in applications where they are an appropriate alternative to continued CFC use. In addition, an HCFC tax may place a stigma on these compounds resulting in their rejection by the lesser developed countries. Since these countries are allowed to use CFCs until 2006, they may wait for the alternatives to HCFCs rather than make a conversion to HCFCs now.

Considerable investments have been made in HCFCs and alternative technology employing HCFC compounds. A tax on these compounds would slow down the shift to these CFC alternatives and could potentially harm many companies, both large and small, which have relied on international and domestic government acceptance of HCFCs in many industrial applications. Any reversal of the federal government's encouragement and support for the use of HCFCs would be unnecessarily detrimental to the industry and to the rapid phaseout of CFCs, with negligible environmental benefit.

Imposition of a tax on the HCFCs would also add to the confusion which has already contributed to negative perceptions of HCFCs. Industry and EPA have worked diligently to develop a positive acceptance of HCFCs and to promote their short-term environmental benefits. The federal government needs to continue its support for these compounds in light of misguided activity at the state and local level to ban HCFCs.

Establishing an HCFC tax now will only penalize consumers and businesses who have just undertaken the cost of making a transition away from CFCs. These consumers and businesses may also have to finance the cost of retrofitting motor vehicle air conditioners and commercial and residential air conditioning and refrigeration equipment if there is a scarce supply of CFCs to service and maintain this equipment after the phaseout.

HCFCs are essential to the preservation of food and medicines, indoor comfort, and energy efficiency. In fact, an HCFC tax would threaten the viability of the whole rigid foam insulation industry which supplies the most energy efficient building insulation. Penalizing consumers for life's essential needs is not productive. These consumers and businesses have already accepted the tax increase passed by Congress this summer. Additional taxes at this time are unnecessary.

Every major industry using HCFCs is working diligently to identify alternatives to HCFCs. These industries need no greater incentive to proceed quickly on this task than the scheduled phasedown in the Montreal Protocol and EPA's forthcoming rulemaking to accelerate the Clean Air Act's HCFC phaseout. These industries have just undertaken the tremendous task of making a rapid transition from CFCs and implementing HCFCs as alternatives. Therefore, they understand the importance of identifying alternatives to HCFCs in order to prepare for the ultimate HCFC phaseout. These industries need to focus their resources on development of alternatives to HCFCs.

HCFCs ARE ENVIRONMENTALLY BENEFICIAL

HCFCs, according to the United Nations Environment Programme (UNEP), are essential bridging compounds that must be commercialized in order to allow for the rapid phaseout of CFCs. The CFC phaseout is the most important step necessary to reduce atmospheric chlorine. A recent UNEP science assessment concluded that the HCFCs are 89%-98% better than the CFC compounds they replace. According to UNEP Science Advisor Robert Watson in November 1992, "It is feasible to phase out of CFCs between 1995 and 1997, assuming an aggressive recycle and retrofit policy and with HCFC substitution for some important uses. HCFCs will be required for a period of time for a number of applications, in particular refrigeration, air conditioning, heat pumps and insulating foams."

The UNEP November 1991 Synthesis Report stated that HCFCs and HFCs "can be safely used for refrigeration, air conditioning, insulating foam, and for some aerosol, sterilization, and minor solvent uses; that these HCFCs and HFCs are environmentally acceptable; and that they are commercially available in adequate quantities."

AN HCFC TAX IS AN INEFFECTIVE REVENUE SOURCE

The ozone-depleting substances excise tax, which was enacted in 1989, has been a poor policy for furthering ozone protection efforts and ineffective as a reliable revenue source. The rapid decline in CFC usage in the United States resulted in the collection of only one-half of the projected revenue from the tax. The acceleration the CFC phaseout well ahead of both the international and domestic phaseout schedules is attributable to the unprecedented cooperation of industry and government in working to achieve the elimination of these compounds on a global basis. CFC reductions in Europe and Japan are equally impressive even though no CFC excise taxes have been imposed. By the end of 1993, CFC production in the United States will be at 25% of 1986 levels. A total phaseout of CFC production will occur by January 1, 1996.

Industry has already identified many technologies that do not use fluorocarbon-based products. At least 50 - 75% of the CFC substitutes market is expected to be replaced by conservation practices and so-called not-in-kind substitution. Projected HCFC utilization is less than 15 - 20% of the CFC market. HCFCs will be used where essential and where no other commercially viable substitutes are available in order to allow the rapid elimination of CFC technologies.

CONCLUSION

We ask the Subcommittee to reject the addition of HCFCs to the list of taxable ozone-depleting chemicals, and to work with industry and the Administration in encouraging the transition to HCFCs for many CFC applications. The ultimate goal of the work that has been conducted by industry and government has been to minimize emissions of ozone-depleting compounds to the atmosphere. The ozone protection effort is succeeding because of the extraordinary cooperation between government and industry at unprecedented levels. (See Attachment 3). Industry will continue to work with Congress and EPA in minimizing confusion over the acceptability of CFC alternatives, and in adhering to a consistent position of acceptability of HCFCs. This proposed change to the tax on ozone-depleting chemicals is inconsistent with these objectives

Attachment 1

1993 Membership List
Alliance for Responsible CFC Policy

3M Company
A. Cook Associates, Inc.
Abbott Laboratories
Abco Refrigeration Supply Corp.
Acme - Miami
American Electronics Association (AEA)
Air Comfort Corporation
Air Conditioning Contractors of America
Air Conditioning & Refrigeration Institute
Air Conditioning Suppliers, Inc.
Air Products and Chemicals
Alliance Pharmaceutical Corporation
AlliedSignal
American Auto. Manufacturers Assoc.
American Frozen Food Institute
American Pacific Corporation
American Refrigerant Reclaim Corporation
American Thermaflo Corp.
American Trucking Associations
Amtrol, Inc.
Anderson Bros. Refrigeration Service, Inc.
Apex Ventilations
ARCA/MCA
Arizona Public Service Co.
Arjay Equipment Corporation
Arrow Air Conditioning Service Company
Arthur D. Little, Inc.
Ashland Chemical Company
Astro-Valcour Inc
AT&T
Automotive Consulting Group, Inc
Bard Manufacturing Co.
Beltway Heating & Air Conditioning Co. Inc.
Beverage-Air
Big Bear Stores Co.
Blue M Electric
Building Owners and Managers Association (BOMA)
Booth Refrigeration Services Conditioning
Bristol Compressors
c/o Moog Training Center
Carrier Corporation

Center for Applied Engineering
Central Coating Company, Inc.
Cetylite Industries, Inc.
Chemical Packaging Corp.
Chemtronics, Inc.
Clayton Auto Air, Inc.
Commercial Refrigerator Manufacturers Association
Copeland Corporation
Day Supply Company
Dow Chemical U.S.A.
E.I. Dupont De Nemours and Company
E.V. Dunbar CO.
Eastman Kodak
Ebco Manufacturing
Elf Atochem North America, Inc.
Elliott-Williams Company, Inc.
Engineering & Refrigeration,Inc.
Falcon Safety Products, Inc.
FES Inc.
Flex-O-Lators, Inc.
Foam Enterprises, Inc.
Foamseal, Inc.
Food Marketing Institute
Foodservice & Packaging Institute
Forma Scientific
Fox Appliance Parts of Augusta
Franke Filling, Inc.
Fras-Air Contracting
Free-Flow Packaging Corp.
Freightliner Corporation
Gardner, Carton & Douglas
Gebauer Company
General Electric Company
General Motors
Graineer
Gulfcoast Auto Air
H. C. Duke & Son, INc.
Hale and Dorr
Halocarbon Products Corporation
Halsey Supply Co., Inc.
Harold Electric Co.
Henry Valve Company
Highside Chemicals
Hill Refrigeration Corp.
Howard/McCray Refrigerator Co., Inc.

Hughes Aircraft Company
Hussmann Corporation
ICI Fluorochemicals - ICI Americas Inc.
IG-LO, Inc.
Illinois Supply Company
IMI Cornelius Company
Institute of Heating & Air Conditioning Industries
Institute of International Container Lessors
Integrated Device Technology Inc.
International Assoc. of Refrigerated Warehouses
International Cold Storage Co., Inc.
International Mobile Air Conditioning Assoc.
Interstate Truckload Carriers Conference
Johnson Controls
Keyes Refrigeration, Inc.
King-Weyler Equipment Co., Inc.
Kline & Company Inc.
Kraft General Foods
KYSOR WARREN
LaRoche Chemicals
Lennox Industries
Liggett Group Inc.
Lintern Corporation
Lorillard Tobacco Company
Lowe Temperature Solutions
Luce, Schwab & Kase, Inc.
Malone and Hyde Inc.
Manitowoc Equipment Works
Marine Air Systems
MARVCO Inc.
Maytag Corporation
McGee Industries, Inc.
Mechanical Service Contractors of America
Merck & Co., Inc.
Metl-Span Corporation
Miles Inc.
Mintz, Levin, Cohn, Glovsky, and Popeo P.C.
Mobile Air Conditioning Society
Monsen Engineering Co.
Montgomery County Public Schools
Moog Automotive Inc.
Moran, Inc.

MRA
Nat. Assoc. Of Plumbing-Heating-Cooling Contractors
National Assn. of Food Equipment Manufacturers
National Refrigerants, Inc.
National Training Centers, Inc.
NC State Board of Refrigeration
Neaton Auto Products Mfg., INc.
New Mexico Engineering Res. Instit.-U of NM
North Colorado Medical Center
Northern Illinois Gas
Northern Research & Engineering Corporation
Northland Corporation
Norton Company-Sealants Division
O'Brien Associates
Omar A. Muhtadi, Inc.
Omega Refrigerant Reclamation
Orb Industries, Inc.
Patterson Frozen Foods, Inc.
Peirce-Phelps, Inc.
Pennzoil Company
Perlick Corporation
Polyisocyanurate Insulation Manufacturers Association (PIMA)
Polycold Systems International
Premier Brands Ltd.
Ralph Wright Refrigeration
Rawn Company, Inc.
Reeves Refrigeration & Heating Supply, Inc.
Refrigeration Engineering, Inc.
Refrigerant Management Services
Refrigeration Sales Co., Inc.
Revco Scientific
Rhode Island Refrigeration Supply Comp, Inc.
Ritchie Engineering Co., Inc.
Rite Off
RJR Nabisco
Robinair Division, SPX Corp
RSI Co.
Rule Industries, Inc.
SCM Glidco Organics
Scott Polar Corporation
Service Supply of Victoria, Inc.
Servidyne Inc.
Sexton Can Company
Sheeting, Metal, Air-Conditioning Contractors National Association (SMACNA)
South Central Co., Inc.

Southern Refrigeration Corp.
Society of the Plastics Industry (SPI)
Sporlan Valve Company
Spray, Inc.
Stoelting, Inc.
Sub-Zero Freezer Company, Inc.
Superior Valve Company
TAFCO Refrigeration Inc.
Tech Spray, Inc.
Tecumseh Products Company
Tennessee Eastman
Tesco Distributors, Inc.
Thermal Engineering Company
Thermo-King Corporation
Thompson Publishing Group
Thompson Supply Co.
Thorpe Supply
Tolin Mechanical Systems Co.
Tomen America Inc.
Trane Company
Tropicana Products Inc.
Tu Electric
Tyler Refrigeration Corp
Union Chemical Lab, ITRI
United Refrigeration, Inc.
Unitor Ships Service, Inc.
University of Maryland at Baltimore
University of Wisconsin-Madison
Valvoline Oil Company
Venable, Baetjer, and Howard
Vulcan Chemicals Co.
W.A. Roosevelt Company
W.M. Barr and Company
Wawa, Inc.
Weinberg and Green
White & Shauger, Inc.
William F. Nye, Inc.
Wynns Climate Control
York Division, Borg-Warner Corp
York International Corporation
Zero Zone Refrigeration MFG
Zexel USA

Attachment 3

8/30/93

Good News, for Once, on Ozone

It's not often that science, industry and government can agree on the causes of a complicated problem and then work to solve it. When they do, there's reason to celebrate. Last week an issue of Nature, a British journal, carried some unexpected good news that is directly traceable to a collective effort: The invasion of the stratosphere by chemicals that thin the earth's protective ozone layer is slowing down.

If the trend continues, the buildup of ozone-destroying chemicals should stop by the year 2000. The worst of the destruction — and it will get worse for a while — should come around the turn of the century when the peak load of chemicals, now wafting upward, reaches the stratosphere. At that point, assuming no new assaults, the ozone layer should begin a slow recovery.

"Here is a beautiful example of science and public policy working well," said Dr. James W. Elkins, a Government scientist who led the team that detected the slowdown.

He's right. Though it took some doing (Donald Hodel, President Reagan's Energy Secretary, once suggested that the way to deal with ozone depletion was to apply more suntan oil), scientists finally persuaded the world's governments that unchecked ozone depletion could, in time, expose large parts of the globe to cancer-causing ultraviolet rays from the sun.

In 1987 industrialized nations agreed to a 50 percent reduction in the main chemical culprit — chlorofluorocarbons, or CFC's, commonly used as a coolant in refrigerators and air conditioners. Three years later, they agreed to eliminate CFC's by the year 2000. Last year, in Copenhagen, the deadline was moved up to 1995.

Meanwhile, manufacturers like du Pont, driven as much by competitive fears as by altruism, moved swiftly to develop substitutes. Most of next year's new cars, for example, will be equipped with non-CFC air conditioning systems. The steady decline in CFC emissions, scientists say, is almost certainly responsible for the slower growth in atmospheric concentrations.

This success story will not be easily replicated. Finding substitutes for CFC's is one thing; finding substitutes for fossil fuels — the main cause of suspected global warming — is quite another. Still, the fact that bureaucrats and business leaders actually responded, once they grasped some unpleasant scientific truths, might be something t remember the next time that querulous countrie get together to talk about the shrinking rain fores or climate change or even the fish in the sea.

New York Times

NY Times 8/26/93 Front Pg.

Scientists Startled by a Drop In Ozone-Killing Chemicals

By WILLIAM K. STEVENS

The buildup of the industrial chemicals most responsible for depleting the earth's protective ozone layer has slowed substantially, Government scientists are reporting today.

If the trend continues, they say, the buildup should stop before the end of the decade. As a result, the worst of the ozone destruction should come around the turn of the century, when the peak load of chemicals, now slowly wafting upward, finally reaches the stratosphere, where ozone depletion occurs.

Then, as the chemicals are gradually destroyed by natural processes, the ozone layer should begin a recovery lasting 50 to 100 years, they say.

The ozone layer keeps the sun's harmful ultraviolet rays from reaching the earth. Unimpeded, those rays can cause skin cancer and cataracts and disrupt ecological processes.

Rapid Cut in Production

The global slowing of the buildup of ozone-destroying chemicals in the atmosphere had not been detected before. It is being attributed to industry's unexpectedly rapid cut in the production of the chemicals even before international agreements to phase them out took full effect.

The effort to rein in the ozone destroyers is widely seen as at least one instance in which government and industry have responded effectively to an environmental threat, once persuaded by scientists of its seriousness.

"Here is a beautiful case study of science and public policy working well," said Dr. James W. Elkins of the National Oceanic and Atmospheric Administration's climate diagnostics laboratory at Boulder, Colo. He was the leader of the team that detected the slowing rate of the chemicals' increase.

'The 2 Big Guys'

The chemicals, called chlorofluorocarbons, or CFC's, have been used as cleaning solvents and cooling agents in air-conditioners and refrigerators and employed in the production of foam packaging materials and insulation. Now they are being replaced in all these uses, producers say.

"We were all caught off guard" by the slowing of the buildup, said Dr. Elkins. "We didn't expect it to occur so soon."

As reported today in the British journal Nature, the scientists measured atmospheric concentrations of the two most important ozone destroyers, CFC-11 and CFC-12, at a number of locations in the Northern and Southern Hemispheres. CFC-11 and CFC-12 "are really the two big guys" most responsible for ozone depletion, said Dr. Elkins, an atmos-

Continued on Page A18, Column 4

Scientists Unexpectedly Finding Less of Ozone-Killing Chemicals

Continued From Page A1

pheric physicist.

He and his colleagues found that the growth rate for concentrations of CFC-11 dropped from an annual average of 11 parts per trillion from 1985 to 1988 to 3 parts per trillion in 1992. For CFC-12, the growth rate dropped from 20 parts per trillion in 1985-88 to 11 parts per trillion in 1992.

"That's good news," said Michael Oppenheimer, an atmospheric scientist with the Environmental Defense Fund, a public-interest group. But while the findings are encouraging, he pointed out, stratospheric ozone "will not return to normal levels for several generations." The reason for the slow recovery is that once the chemicals are in the atmosphere, concentrations decline only over decades — at least 40 years for CFC-11 and as much as 140 years for CFC-12.

Many see science and public policy working together.

Moreover, Mr. Oppenheimer said, several other ozone-destroying chemicals, including especially the pesticide methyl bromide, are not yet fully regulated by international treaty.

Nevertheless, Dr. Elkins said, solving the CFC problem would solve the bulk of the ozone-depletion problem, especially since another class of ozone destroyers, the halons, have also been accumulating at lower rates. Halons, which are used in fire extinguishers, are actually more potent ozone-eaters, molecule for molecule, than CFC's. But there are less of them in the atmosphere, and they consequently destroy far less ozone.

Greater Depletion Found

Under an agreement signed by 87 countries last November in Copenhagen, the manufacture of CFC's is to be phased out by the end of 1995, while halon manufacture is to stop by the end of this year. Controls were first placed on CFC production by the Montreal Protocol of 1987.

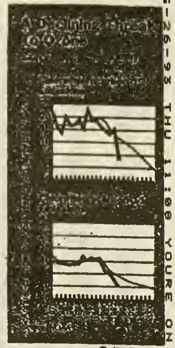
The deadlines were moved up in 1990 and again last November after scientists found that ozone depletion was more extensive than had been believed. In October 1991, for instance, scientists working under United Nations auspices reported for the first time that the ozone layer in the latitudes of the United States had depleted in the previous summer.

In response to these findings, E. I. du Pont de Nemours & Company, the world's largest manufacturer of CFC's and halons, announced that it was speeding up its phase-out by three to five years after surprising the world three years earlier by pledging to eliminate them by 2000. Other manufacturers around the world have followed suit.

An analysis by Du Pont scientists included in today's report found a decline in emissions of CFC-11 and CFC-12 because of shrinking production over the last few years. The decline of emissions matched the slowing of the growth of atmospheric concentrations, leading researchers to conclude that one caused the other.

CFC's have been largely eliminated as spray propellants, as cleaning solvents and as ingredients in plastic-foam products like drinking cups and packing materials. That accounts for roughly half the original market, sa Tony Vogelsberg, the environment manager of Du Pont's fluorochemica division. Replacing CFC's as coolan in air-conditioners and refrigerator the main use of CFC-12, has prov more difficult.

Automobile air-conditioners are t largest single group emitting CFC-1 Mr. Vogelsberg said. New cars a rapidly being equipped with air-con tioners using substitutes. "About 1 percent of the new cars in the 19 model year will be CFC-free, startin this month," he said. But the industr still sells CFC's to service older aut motive air-conditioners. In two year when CFC's are no longer produce owners of those cars will have to us recycled CFC's or replace their ai conditioners with CFC-free ones.



The New York Times

Decline of Ozone-Harming Chemicals Suggests Atmosphere May Heal Itself

By Boyce Rensberger
Washington Post Staff Writer

The amount of ozone-destroying CFCs in the atmosphere, which had been rising rapidly for decades, suddenly slowed its rate of increase in 1989 and has nearly leveled off since then, scientists at the National Oceanic and Atmospheric Administration have found.

The NOAA researchers credit a surprisingly rapid decline in the production and use of the chemicals—called chlorofluorocarbons and sold mainly as refrigerants and plastic foam-blowing agents—and forecast that their concentration will peak around the year 2000.

If current trends continue, they say, CFC levels will slowly decline, allowing the ozone layer to heal itself naturally and provide steadily increasing amounts of protection against the sun's ultraviolet rays.

"This is extremely good news for the environment," said James W. Elkins of NOAA's Climate Monitoring and Diagnostics Laboratory in Boulder, Colo. Elkins led the research effort, with colleagues at NOAA and the University of Colorado, that has been tracking CFC concentrations since 1977. Elkins said that when his group first saw the drop in the CFC growth rate, it was so dramatic, "our first reaction was [that] we've got something wrong with our instruments."

The data—which have been circulating privately among scientists for more than a year, and on which The Washington Post based an earlier report that the ozone problem would peak in 2000—are published in today's issue of the scientific journal Nature. The findings were submitted to Nature in June 1992; but because the journal prohibits scientists from presenting their work publicly while it is undergoing peer-review, Elkins and the other authors could not talk about their findings until now.

"I'm very pleased that this is out," said Richard Stolarski, an ozone-layer researcher at NASA's Goddard Space Flight Center in Greenbelt. "It's very welcome experimental confirmation of what many of us had projected on the basis of [CFC] production figures. It's actually amazing how fast some of these growth curves drop off."

CFCs, which were invented in the 1920s but did not come into widespread use until the 1950s and 60s, are blamed for about three-quarters of the depletion of ozone. In recent years, the loss over temperate zones has been about 3 percent to 4 percent. In the last two years, however, occasional losses have surged to as much as 10 percent to 15 percent for brief periods. These are generally attributed to effects from the 1992 eruption of Mount Pinatubo, which are expected to fade in coming years.

The new CFC report was based on measurements of air samples collected at seven stations around the world in polar, temperate and tropical regions. Starting in 1977, samples of air were taken weekly

See OZONE, A11, Col. 1

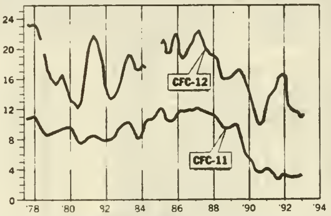
THE CFC FLOOD IS CRESTING

The amounts of CFC-11 and CFC-12 that are being put into the atmosphere each year began to decline after 1988. Upper panel shows the average amounts released each month. Lower panel shows how those amounts caused the total concentrations to rise steadily until the late 1980s, when the curves began to flatten. Measurements were made in the lower atmosphere. It takes two to four years for CFC changes there to reach the stratosphere, where the ozone layer is.

Gaps resulted from malfunctions in analytic equipment. Fluctuations are caused by changes in global wind patterns that spread CFCs, which are released primarily in the industrialized world.

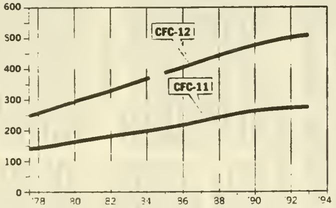
OUTPUT OF CFC-11 AND CFC-12

IN PARTS PER TRILLION



TOTAL CONCENTRATION OF CFC-11 AND CFC-12

IN PARTS PER TRILLION
AVERAGE FOR SEVEN STATIONS TAKEN AT GROUND LEVEL



Source: NOAA

THE WASHINGTON POST

THE WASHINGTON POST

CFCs' Threat to Earth's Ozone Layer Will Diminish After 2000, Study Says

OZONE, From A10

from each station and shipped to Elkins's laboratory for analysis.

The new report concerns the two most common and fastest growing types of the chemicals: CFC-11 and CFC-12. From 1977 through 1984, the concentration was rising at an annual average of 9 parts per trillion (ppt) for CFC-11 and 17 ppt for CFC-12.

In 1984 production and use of the chemicals increased; and from 1985 to 1988, the CFC-11 concentration grew at a rate of 11 ppt each year while CFC-12 grew 19.5 ppt each year.

Then, Elkins said, something "surprising" happened. After 1988 the rate of increase plummeted, reaching levels this year of 2.7 ppt for CFC-11 and 10.5 ppt for CFC-12.

After establishing that the instruments were not malfunctioning, Elkins recalled, he became puzzled as to why CFC release would be slowing its growth even though the Montreal Protocol—a global treaty signed in 1987 to phase out use and end the production of ozone-destroying chemicals—was not due to take full effect until 1996. He called E. I. du Pont de Nemours & Co., which makes the chemicals, and learned that their estimates of the amount produced around the world showed a parallel decline.

Elkins and colleagues estimated that if CFC output trends continue to fall and production ceases in 1996, as planned, the concentration of CFC-11 in the lower atmosphere will peak in 1998 and CFC-12 a year later. Because it takes two to four years for molecules in the lower atmosphere to reach the stratosphere, where the ozone layer is, the amounts there would not be likely to peak until shortly after 2000.

At that time, the group estimated, the concentration of chlorine (the atom that breaks off CFC and attacks ozone) in the stratosphere would be about 4 parts per billion, up from the current 3.4 ppb.

After the peak, however, the chlorine would slowly fall out of the atmosphere. Small amounts are removed all the time as the chlorine combines with hydrogen to form hydrochloric acid in water droplets that eventually fall in rain.

The scientists estimate that it could take 50 to 100 years before the concentration of stratospheric chlorine returns to levels thought to have existed before the widespread use of CFCs—about 0.5 ppb. Elkins said that if the world can make it to 2000 without suffering any major harm from ozone depletion, he would not expect any catastrophes to arise during the long recovery period.

He credited the CFC decline to public pressure. "This is all driven by U.S. public opinion," he said. Adverse publicity about CFCs has meant "consumers won't buy products made with CFCs."

At the same time, the chemical industry apparently has embraced the goals of the Montreal Protocol, at least in part because firms saw profitable new markets in costlier CFC substitutes.

"This is a beautiful case study," Elkins said, "where science, the law, industry and the public worked together."

One caveat remains. Third World signatories, which include such large and growing refrigeration markets as China, India and Indonesia, are allowed to delay their phaseout of CFCs for 10 years. To help them meet the higher costs of substitute chemicals and refrigeration hardware built to use the substitute, the protocol allows them to draw on a fund to which the rich countries would contribute.

Although these countries are not large users of CFCs now, there is a fear that in their drive to develop economically and to improve public health through wider use of food refrigeration, they may increase use of the cheap ozone-destroying chemical rather than more costly substitutes.

In the industrialized world, the phaseout is likely to be smoother. According to the Air Conditioning and Regrigeration Institute, all home air conditioners, including central and window units, already use one of the substitutes—HCFC-22, or hydrochlorofluorocarbon-22. Pound for pound, HCFC-22 can do only about 5 percent as much harm to the ozone layer as CFCs. Home refrigerators use CFC-12 but rarely need recharging before the unit wears out mechanically. Refrigerators that use ozone-safer coolants are starting to come on the market.

Most automobile air conditioners, until the 1994 model year, were built to use CFC-12. Nearly all '94 models will use a hydrofluorocarbon coolant, HFC-134a, that contains no chlorine and thus cannot harm ozone. Because car air conditioners are notorious for leaking (mainly because of vibrating hose connections), most existing units will eventually need recharging with CFC-12 or replacement with a new unit that works on HFC-134a.

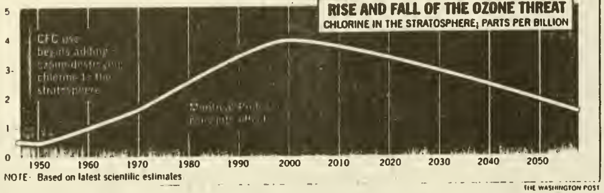
Even after the ban on making new CFCs, however, experts say it should still be possible for a few years to recharge older units with recycled CFC-12. The cost of retrofitting a car with an HFC-134a air conditioner has been estimated at $200 to $800.

The Washington Post

16TH YEAR .... No. 131 THURSDAY, APRIL 15, 1993

After 2000, Outlook for the Ozone Layer Looks Good

By Boyce Rensberger
Washington Post Staff Writer


RISE AND FALL OF THE OZONE THREAT
CHLORINE IN THE STRATOSPHERE; PARTS PER BILLION

NOTE: Based on latest scientific estimates
THE WASHINGTON POST

After nearly a decade of headlines and hand-wringing about erosion of the Earth's protective ozone layer, the problem appears to be well on the way to solution.

As a result of the Montreal Protocol, an international treaty obliging signatory countries to phase out ozone-destroying chemicals, scientists expect the threat of ozone destruction to peak in just seven years. In 2000, according to the latest scientific estimates, the ozone layer should start slowly getting thicker and better able to block the sun's harmful ultraviolet (UV) rays.

In fact, researchers say, the problem appears to be heading toward solution before they can find any solid evidence that serious harm was or is being done.

This hopeful trend—at variance with the dark scenarios of environmental doom that were pronounced after discovery of the Antarctic ozone hole in the 1980s—is supported not only by growing scientific evidence but even by scientists in the environmental movement.

"The current and projected levels of ozone depletion do not appear to represent a catastrophe," said Michael Oppenheimer, an atmospheric scientist with the Environmental Defense Fund. "But I'm flabbergasted that we let it go this far before taking action. It was a potentially very serious problem."

Richard Stolarski, an atmospheric scientist at NASA's Goddard Space Flight Center, agreed: "I happen not to be of the disaster school. It's a serious concern but we can't show that anything really catastrophic has happened yet, or that anything catastrophic will happen in the future."

Attempts to detect the most feared effect of ozone depletion—increased bombardment of the Earth's surface by UV rays—have failed to turn up any evidence of increased ultraviolet influx outside the Antarctic region during the few weeks each year that the ozone hole is open.

If there has been any increase in UV, researchers say, it is too small to measure against a background of normal ultraviolet levels that rise and fall by large amounts for entirely natural reasons on time scales from hours to decades.

Given the expected improve-

See OZONE, A18, Col. 3

The Washington Post … Thursday, April 15, 1993 A19

In the Debate About Ozone, No Depletion in Rhetoric

Public debate over the possible effects of an eroding ozone layer often has been characterized by inflammatory claims and doomsday rhetoric.

Vice President Gore's popular book, "Earth in the Balance: Ecology and the Human Spirit," says ozone depletion has become so bad that hunters in Patagonia are finding rabbits blinded by increased ultraviolet. Anglers, Gore reports, are catching blind fish. Other accounts add that Patagonian sheep are going blind.

The reports have gained credibility because Patagonia is at the tip of South America, not far from the Antarctic ozone hole. Yet, efforts to link the rabbit and fish claims to ozone depletion have failed. And the sheep, it turned out later, just had eye infections.

While ozone scientists have not made such claims, some have adopted similarly dramatic language. In a booklet called, "Report to the Nation: Our Ozone Shield," researchers at the National Oceanic and Atmospheric Administration say, "life as we know it is possible in part because of the protection afforded by the ozone layer," but that it is now "in jeopardy." They called the discovery that industrial chemicals are to blame "a dark message for the world."

Even environmentalists have found some of the debate hard to take. "Unfortunately, we have very little hard data on the effects of ozone depletion," said Michael Oppenheimer of the Environmental Defense Fund. "To begin with, no one knows how much increase in ultraviolet there's been. All we can really say is that there has been a likelihood of some increase in some areas. When there isn't much data, there's room for lots of wild speculation."

One of the most widely repeated claims is that during the past decade skin cancer rates—known to be linked to UV exposure—have doubled. While true, the fact is that skin cancer rates have been climbing steadily through most of this century.

According to data from the American Cancer Society, for example, the skin cancer rate in the United States now is nearly eight times higher than it was 30 years ago. Because there is a long lag between exposure and disease, the 732,000 Americans who are expected to get skin cancer this year will be suffering for their exposure to ultraviolet long before CFCs became a threat.

Decline Found in Planktonic Organisms

The rising trend, cancer researchers say, is the result not of ozone depletion or increased UV (if anything, UV levels have declined in populated areas because of increasing low-altitude air pollution), but of lifestyle changes such as wearing skimpier clothing in summer, spending more time outdoors and spending more of that time in southerly latitudes.

Still, it is true in principle that if ultraviolet levels increase, they should raise the number of skin cancer cases—at least among light-skinned people—and assuming the trend toward less tanning and more use of sunscreens does not continue. One rule of thumb scientists use is that for every decline of 1 percentage point in ozone, there is a 1.3 percentage point increase in the amount of DNA-damaging UV.

The only credible claim of a biological effect that has already occurred comes from those who study microscopic creatures in the ocean surrounding Antarctica. Ray Smith of the University of California at Santa Barbara has found evidence of a 6 to 12 percent decline in the number of these planktonic organisms while the ozone hole is open. Some other scientists criticize Smith's methods and say the results probably overestimate the damage.

"One problem is that we only began studying this after the ozone hole was in existence," said Deneb Karentz of the University of San Francisco, who also studies Antarctic plankton. "If there were organisms that were extremely sensitive to UV, they could be gone now."

Despite the hole, the planktonic organisms are not helpless. Karentz has discovered that virtually all of them can protect themselves against increased ultraviolet with a natural sunscreen, a colorless molecule that absorbs UV-B. Algae make the sunscreen in response to an increase in UV. Planktonic animals extract it from the algae they eat and, instead of digesting the molecules, distribute them in their own bodies.

So effective is the molecule, Karentz said, that an Australian firm is working to synthesize the substance and sell it as a natural sunscreen for humans.

Testing for Effects of Higher UV Levels

Botanists have found that land plants also make their own natural sunscreens, molecules called flavenoids. These molecules are analogous to the melanin that human skin makes to tan itself for protection from ultraviolet, except that plants can do it much faster. Some plants respond within hours to changes in UV level, increasing their flavenoid content each morning as the sun moves higher, lowering it if the day turns cloudy to take in more of the visible wavelengths needed for photosynthesis, and dropping it to low levels through the night.

Flavenoid content also varies with latitude. The farther south a species' growing range, the higher the flavenoid content. But each species has a limit. If it is transplanted still farther south, the plant may not be able to make enough flavenoid to protect itself and its growth will be retarded.

While scientists find no solid evidence that land plants are suffering from increased ultraviolet bombardment, experiments are under way to see what might happen in the future if UV levels go up significantly.

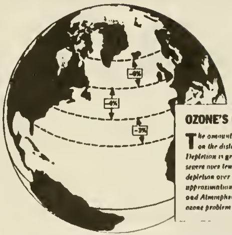
Alan Teramura of the University of Maryland, for example, has been growing various food crops and tree species under sunlamps that boost the UV levels by as much as 50 percent. This is several times as much extra ultraviolet as is expected in 2000, when ozone depletion is projected to reach its worst.

At these high doses, about two-thirds of the 50 varieties tested displayed reduced yields. The most sensitive soybean varieties, for example, lost as much as 25 percent of their yield. Other varieties were unchanged and a few increased their yields slightly. Because soybeans are Maryland's leading field crop, researchers are working to develop varieties with enhanced UV-B resistance.

The effect on perennial species such as loblolly pines was more insidious. Teramura has found that with each passing year, the trees' growth was stunted by a larger amount. Studies are continuing to see whether the effect of massive UV doses will eventually kill the trees.

"The effects in trees that we see now may be small and subtle but they accumulate over time," Teramura said.

Still, "I'm optimistic," said the Environmental Defense Fund's Oppenheimer. "I believe the Montreal Protocol is already solving the problem before it gets out of control."



OZONE'S CHANGES IN LATITUDE

The amount of ozone depletion varies depending on the distance from the pole or equator. Depletion is greatest over polar regions and less severe over temperate zones. There is no measured depletion over the tropics. Losses shown here are approximations published in a National Oceanic and Atmospheric Administration booklet on the ozone problem.

THE WASHINGTON POST

Unexpectedly Fast Phaseout

Montreal Protocol Set Year 2000 as the End of CFC Use

The Montreal Protocol was negotiated by environmental ministers from 24 industrialized countries in the Canadian city during September 1987. Signatory nations agreed to freeze production and use of CFCs and halons (other less common ozone-destroying chemicals) at 1986 levels and then to reduce the amounts by 50 percent over the ensuing 10 years.

Since then, the chemical industry, sensing a burgeoning new market, moved so fast to develop replacements—and industries adopted them so quickly—that the phaseout has moved faster than expected.

As a result, when the negotiators met again in 1990, they agreed to end all use of CFCs and most halons by 2000. This is why scientists say the ozone layer will start getting thicker in that year. Although CFCs can survive several years in the atmosphere, small amounts are being destroyed naturally each year; once the manmade supply ends, natural destruction will become the dominant factor.

A major step toward reducing CFC production was taken in 1979 when the United States banned the chemicals' use in aerosol spray cans.

Although some replacement chemicals called HCFCs (hydrochlorofluorocarbons) are chemically similar to CFCs and still contain chlorine, their modified structure is said to make them less threatening to the ozone layer. They react more easily with other substances in the lower atmosphere and are largely broken down before they can reach the stratosphere.

CFCs also are being replaced by a variety of other chemicals, differing according to the application. Also playing roles are changes in manufacturing processes that once depended on CFCs as solvents and foam blowing agents. New types of refrigerators and air conditioners are being developed to run on several other sorts of coolants.

In fact, engineers say that as they redesign cooling equipment to run on different fluids, they will take the opportunity to incorporate other improvements in refrigeration technology that will reduce the energy consumption. Economists have calculated that the saved energy cost would more than pay for the higher cost of the CFC replacements.

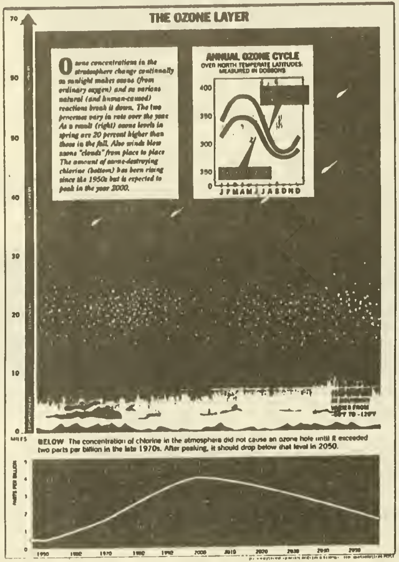
Although many environmentalists say the protocol has been a major success, many still worry because China, India and other developing countries have not signed it. As these countries become more industrialized—and use of refrigeration and solvents grows—they likely will find CFCs attractive because the chemicals are cheap, effective and nontoxic. Substitutes are more costly.

Environmentalists are pushing for development of cheaper replacements and urging Third World countries to sign the treaty.

—Boyce Rensberger

Next Century Should See Reversal of Ozone Depletion

THE OZONE LAYER



Ozone concentrations in the stratosphere change continually as sunlight makes ozone (from ordinary oxygen) and as various natural (and human-caused) reactions break it down. The two processes vary in rate over the year. As a result (right) ozone levels in spring are 20 percent higher than those in the fall. Also winds blow ozone "clouds" from place to place. The amount of ozone-destroying chlorine (bottom) has been rising since the 1950s but is expected to peak in the year 2000.

BELOW The concentration of chlorine in the atmosphere did not cause an ozone hole until it exceeded two parts per billion in the late 1970s. After peaking, it should drop below that level in 2050.

OZONE, From A1

ments in the ozone layer, even the ozone hole eventually could stop opening. Already scientists see signs that the hole is not likely to grow much bigger than it has.

Even when the problem reaches its worst in 2000, scientists expect summertime ozone losses over temperate zones to be about 8 percent, double what they are now. Because each percentage point of ozone loss theoretically leads to an increase in UV intensity of 1.3 percentage points, the potential increase in ultraviolet would be about 8 percent.

Scientists calculate that the increased UV exposure a Washingtonian would get in midsummer then will be the equivalent of moving south about 200 miles now. In other words, if you want to know what this area's ultraviolet level will be like in July 2000, go to, say, Raleigh, N.C., this July.

Worst Depletion Occurs in Late Winter

Latitude is crucial because, like time of day and season, it affects the amount of atmosphere that UV must pass through to reach the ground. When the sun is directly overhead, for example, its light penetrates one thickness of atmosphere, but when it is on the horizon, its rays take a slanting path roughly equivalent to 40 thicknesses, and 40 times as much ozone.

This is key to understanding why, even though ozone depletion is worst in late winter (ozone is reduced by 8 to 10 percent), less ultraviolet gets through than in summer, when the ozone loss is milder. Sun angle is so low in winter that the UV passes through more ozone then than during summer when there is less depletion. (Over the tropics, where sun angle is high all year long, there has been no observed ozone depletion.)

"One reason we haven't seen any increase in UV is that we didn't start taking good data long ago," said Stolarski, who nearly 20 years ago was among the first researchers to assert that the ozone layer could be damaged if certain chemicals—especially chlorine—traveled high enough in the atmosphere.

Ultraviolet Rays Fluctuate Naturally

Because of natural fluctuations in ultraviolet, it is impossible to detect a trend in a short period of data collection.

While there is evidence that the ozone damage is happening, it has proven impossible so far to detect any resulting increase in UV reaching the ground because ultraviolet fluctuates so much naturally.

"The amount of increase that the theory says we could be getting from ozone depletion is smaller than the error of our best measuring instruments," said John E. Frederick, an atmospheric physicist at the University of Chicago.

"People get all excited about a few-percent change in UV, but it's nothing to get a 20 percent increase naturally," Frederick said. "If an increase of 20 percent were going to be so damaging, there should be no life in Florida," where ultraviolet always exceeded the allegedly dangerous levels once forecast for more northerly latitudes.

Los Angeles Pollution Cuts Levels of UV

Stolarski, Frederick and other atmospheric scientists say that even if there were good UV measurements going back many years, they still might not show an increase because other factors such as increased cloudiness (one of the predicted effects of global warming) and air pollution (including pollution by ozone in the lower atmosphere) might be shielding the ground, compensating for the lost upper-atmosphere ozone.

That, in fact, was a conclusion of one of the most exhaustive studies of the ozone problem ever undertaken, an effort in which nearly 150 scientists from 28 countries collaborated under the auspices of five American, British and United Nations agencies.

"The decreases in UV-B [the damaging form of UV] caused by increases in [air pollution] since the industrial revolution probably exceed the increases due to ozone depletion," according to the group's latest report, "Scientific Assessment of Ozone Depletion: 1991."

In Los Angeles, Frederick said, there is so much extra ozone in the lower atmosphere in the form of air pollution from cars that it cuts the ultraviolet level on an average day by 0 to 9 percent. On smoggy days, the UV level drops by 20 percent.

Without Shield, Almost Uninhabitable Earth

If any of this comes as a surprise, it may be because most of the mass media coverage of this complex issue has focused on cries of alarm by environmentalists who feared a worst-case scenario in which the planet's protective ozone layer would be thinned enough to let in massive amounts of solar radiation.

If the ozone shield did not exist, the surface of the Earth would be virtually uninhabitable. The amount of ultraviolet that reaches the top of Earth's atmosphere would be lethal to most forms of life if it penetrated to the ground.

The world responded to the environmentalist case: The main threats to the ozone, synthetic chemicals called chlorofluorocarbons (CFCs) used chiefly as refrigerants, solvents, foam blowing gas, and once as spray-can propellants, are being phased out. In fact, production and sales of CFCs are declining faster than originally projected by negotiators of the Montreal Protocol.

So well are the corrective measures proceeding that scientists who have been looking for effects of ozone depletion say it may not be possible to document any before the massive injection of CFCs into the atmosphere fades away, ending humanity's inadvertent experiment in perturbing Earth's atmosphere.

Nevertheless, debate over various facets of the subject is likely to continue. What follows is a reader's guide to the facts underlying the controversy.

Contrary to Popular Notion, Ozone Is a 'Renewable Resource'

Ultraviolet Radiation Has Created, Destroyed the Substance for Eons

The destruction of ozone—a form of oxygen in three-atom clusters—is nothing new in the atmosphere. It was happening naturally for billions of years before E. I. du Pont de Nemours and Company Inc. invented CFCs and for several different reasons. For one thing, ozone is destroyed by the very act of absorbing ultraviolet radiation. And, paradoxically, ozone is created by ultraviolet radiation.

In other words, the ozone layer—contrary to popular impression—is not a limited resource that is being irreparably destroyed. In fact, ozone is made so rapidly in the upper atmosphere that the entire amount destroyed in the annual Antarctic ozone hole (up to 70 percent of what was there) is entirely replaced long before the next hole develops. "Ozone," as Stolarski puts it, "is a renewable resource."

Ozone's life cycle takes place mainly in a slab of atmosphere called the stratosphere, the second layer up from the ground.

The lowest layer, the troposphere, varies in thickness from about six miles at the poles to about 10 miles over the tropics. It contains 80 percent of the mass of air but only about 4 percent of its thickness, figuring that the atmosphere goes up about 250 miles.

The defining characteristic of the troposphere is that the temperature drops as one rises through it in altitude. At the top of the troposphere the air temperature ranges from 60° Fahrenheit over the poles to 120° over the tropics.

(The top of the troposphere is highest and coldest over the tropics because the region's fast rising warm air puffs the atmosphere up. The rising air mass then splits into northbound and southbound air masses, cooling and sinking as they move. This flow transports the ozone made in the tropics to the poles.)

In the stratosphere the temperature profile is reversed. The higher you go, the warmer it gets until, at its top—about 30 miles above the ground—it can be as toasty as 45° F over the summer pole and a not quite balmy -27° over the winter pole.

Ozone is what warms the stratosphere. When an ozone molecule absorbs a dose of ultraviolet light, the solar energy turns into heat. While ozone can be found through the entire atmosphere, it is thickest at around 15 miles of altitude, roughly the center of the layer.

Even there, however, it is a rare gas, accounting for just one in every 100,000 molecules in the ozone layer. (Roughly 80,000 are nitrogen and 20,000 are ordinary oxygen.)

Solar Rays Strike Oxygen Molecules

So scarce is ozone that if the 250-mile thickness of the atmosphere were squeezed down so that it was all at the same pressure as at sea level, the atmosphere would be just five miles thick and the ozone would account for just 1/8 inch of it.

Ozone is created (mainly in the stratosphere) when highly energetic solar ultraviolet rays strike molecules of ordinary oxygen (O_2, sometimes called molecular oxygen) and split apart the two oxygen atoms. If a freed atom bumps into another O_2, it joins up, forming O_3, which is ozone.

This new molecule has the special ability to absorb a certain class of ultraviolet rays called ultraviolet B, or UV-B, which have a wavelength that is especially damaging to living cells. UV-B passes through ordinary oxygen and nitrogen like light through glass.

When ozone absorbs UV-B, it is destroyed, splitting into ordinary oxygen and a free oxygen atom. Usually the loosed oxygen atom links up with another ordinary oxygen molecule to form a new ozone molecule ready to take another dose of UV-B. But if the atom collides with an ozone molecule, it steals one oxygen atom, yielding two molecules of ordinary oxygen.

"The lifetime of an ozone molecule is just a matter of minutes if it's at high altitude," said Bill Mankin, an ozone researcher at the National Center for Atmospheric Research in Boulder, Colo., "but if it's farther down in the atmosphere, the lifetime can be months."

The difference exists because the low-altitude ozone is shielded from ultraviolet light by the ozone above it. Loss of this shielding effect, for example, after the ozone hole opens over Antarctica, speeds up the destruction and creation of new ozone.

Amount of Ozone in Any Location Varies

In their brief lifetimes, ozone molecules drift and swirl above the Earth's surface, blown in varying concentrations by wind. Atmospheric scientists say that if ozone were visible from space, its changing concentrations would look much like the familiar weather satellite images of moving clouds.

Because of this constant movement, the amount of ozone above any given spot on the planet—and hence the amount of ultraviolet light filtered out—can vary widely from hour to hour. Ozone concentrations also change more predictably on separate natural cycles of one day, one year, two years, and 11 years.

There are two reasons why there is such uncertainty—among scientists if not environmentalists—about the relative danger of ozone depletion. One is that all living things have been coping with large swings in ozone and hence UV radiation, for millions of years. The other is that because of these natural swings, measurements of ozone levels go up and down in irregular ways and it is hard to see a long-term trend against the background. Scientists refer to it as trying to pick out the signal from the noise.

For example, the annual cycle means that the amount of ozone in the atmosphere above temperate latitudes is naturally about 20 percent higher in April than it is in October. The actual number varies from year to year; 20 percent is an average over the past 60 years.

The natural 20 percent drop in ozone levels is four or five times the 4 to 5 percent drop attributed to human causes—although, of course, in any given moment, the human effect is added to the natural effect.

Amounts of ozone over tropical regions also vary by about 4 to 5 percent over a roughly two-year cycle, in step with a biennial reversal of the prevailing high altitude winds over the equator. In addition the roughly periodic warming of the southern Pacific Ocean surface known as El Niño also causes tropical ozone levels to fluctuate by 3 to 4 percent. Sometimes El Nino and the biennial reversal are in phase, their effects adding together; at other times they almost cancel out each other.

Even the 11-year sunspot cycle plays a role, the presence of sunspots corresponding to times when the spectrum of solar radiation is most favorable to creating ozone.

"You've got to take the solar cycle into account," said James Angell, who monitors global ozone cycles for the National Oceanic and Atmospheric Administration. "If you don't, you could see an ozone change and think that something else caused it."

Angell's data show that global ozone levels rise and fall about 2 to 3 percent through a normal solar cycle. For example, from 1979 (a maximum in the sunspot cycle) to 1985 (a minimum) global ozone levels dropped because of the solar cycle. This happens to be the period in which the Antarctic ozone hole was first detected.

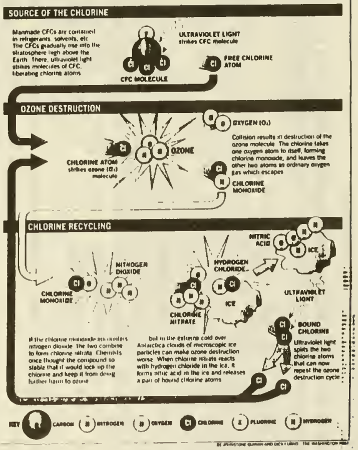
Since then, the cycle rose again, peaking in a maximum that ran from 1989 through 1991. But during what should have been a period of high ozone production, Angell's observations show ozone declined by 2.7 percent. This suggests other factors, possibly including human causes, pushed depletion faster than creation.

One of the big unknowns, incidentally, is whether the depletion of ozone over temperate latitudes has anything to do with the ozone hole over the South Pole. One theory suggests that destruction of ozone there is slowly draining ozone from all over the world faster than it can be recreated. A rival theory holds that temperate zone ozone is being broken down by a separate phenomenon.

"All the factors that affect ozone go on simultaneously and that makes it very hard to pick out any one of them and say it's responsible for thus and such a part of the change," Stolarski said. "Some things are extremely solidly known and some are not. One thing we can say is that we are very confident the overall depletion of ozone is real."

HOW CFCs DESTROY OZONE OVER ANTARCTICA

The chemical reactions that lead to runaway breakdown of ozone above the South Pole have only recently been understood. There are several possible chemical pathways and chemists debate which are predominant. This is one set of reactions that experts agree accounts for most of the ozone loss.



Manmade CFCs are contained in refrigerants, solvents, etc. The CFCs gradually rise into the stratosphere high above the Earth. There, ultraviolet light strikes molecules of CFC, liberating chlorine atoms.

Collision results in destruction of the ozone molecule. The chlorine takes one oxygen atom to itself, forming chlorine monoxide, and leaves the other two atoms as ordinary oxygen gas which escapes.

If the chlorine monoxide encounters nitrogen dioxide, the two combine to form chlorine nitrate. Chemists once thought the compound so stable that it would lock up the chlorine and keep it from doing further harm to ozone...

...but in the extreme cold over Antarctica clouds of microscopic ice particles can make ozone destruction worse. When chlorine nitrate reacts with hydrogen chloride in the ice, it forms nitric acid in the ice and releases a pair of bound chlorine atoms.

Ultraviolet light splits the two chlorine atoms that can now repeat the ozone destruction cycle.

BY JOHNSTONE QUINAN AND DICK FURNO — THE WASHINGTON POST

Mr. JACOBS. Thank you, Mr. Fay.

Ms. Hecht, nice to have your company.

STATEMENT OF MARJORIE MAZEL HECHT, MANAGING EDITOR, 21ST CENTURY SCIENCE & TECHNOLOGY

Ms. HECHT. Thank you, Mr. Chairman.

I am Marjorie Hecht and I am representing 21st Century Science Associates, publishers of the magazine 21st Century Science & Technology, and the book The Holes in the Ozone Scare: The Scientific Evidence that the Sky isn't Falling.

We strongly oppose the proposal to add methyl bromide, HCFCs and HBFCs to the list of taxable ozone-depleting chemicals. The actual cost to the Nation of such a tax would be crippling when measured in food losses and economic losses, and it will not protect lives. Indeed, it will damage lives here in the United States and worldwide.

The proposal of such a tax continues the unscientific flight forward pattern that has become U.S. policy regarding ozone depletion. This is a policy based on public perception and hypothetical models, not scientific evidence. It is a policy pushed very hard by environmental organizations and some research groups, backed by millions of dollars from foundations and corporations.

The alleged dangers of ozone depletion have been repeated so often by these groups and the media that they have come to be accepted as truth without question. I would like to raise some of the questions in this testimony that I think committee Members should address before continuing this ozone flight forward.

My perspective in this is to look at the consequences of the Nation's policy on ozone depletion in terms of human lives, how many lives will be lost as a result of these policies. I am not a scientist, but a science writer and editor and have been for 20 some years, and I have considered the evidence presented by many experienced scientists worldwide whose work does often not get printed in the popular press or even in the scientific press because it is not, "politically correct."

First, what is the worst-case scenario if the ozone depletion theorists are correct? They say we will have a 10 percent ozone depletion within the next 50 years. What does that translate to in terms of the alleged increase in ultraviolet radiation reaching earth? It means an increase equivalent to that you would receive if you moved 100 miles south toward the equator. In other words, from Washington to Richmond, Virginia.

When we put this fact of moving 100 miles south to the inventor of the ozone depletion theory, Professor F. Sherwood Rowland, he acknowledged that this is not something he would worry about, moving 100 miles or so south. Clearly this is not a crisis situation for most people.

Is such a worst-case ozone depletion scenario worth the disruption of refrigeration worldwide and trillions of dollars of cost incurred by the ban on CFCs and now a coming ban on methyl bromide? I don't think so.

Second, has any increase in ultraviolet actually been measured? No. There is no trend of an increase of ultraviolet reaching the Earth. The most definitive study by U.S. researchers Scotto and

Urban over more than a 12-year period showed no significant increase in UVB, and some stations in the U.S. showed decreases.

Third, is there significant scientific evidence to indicate that ozone depletion is natural, seasonal, and a cyclical phenomenon that seems to follow the sunspot cycle? Yes. I won't go into the details of this evidence which is in my written testimony.

Fourth, what about natural sources of chlorine? They admittedly dwarf manmade sources. There are millions of tons of natural sources from sea water, volcanoes, et cetera, but only a few thousand tons of manmade sources of chlorine from CFCs.

Do natural sources of chlorine reach the stratosphere? The ozone depletion theorists assert they do not. The scientific evidence indicates that they do. Again, this evidence, some of it, is listed in my written testimony.

There are many more basic questions that could be asked about ozone depletion. Global ozone has been increasing over the last six years, for example. How could this be, given the current ozone depletion theory?

I won't talk about methyl bromide because I think others here will talk about how essential it has been. I do want to conclude by talking about the human consequences of the ban on CFCs. I know that these were not even considered when the ban was proposed.

We asked EPA Administrator William Reilly at a press conference in November whether the EPA had evaluated the consequences worldwide of a phaseout of methyl bromide. They hadn't. In other words, the EPA was making a decision based on uncertain science, and they hadn't even bothered to assess the damage it would cause.

Now, I want to conclude by asking the question, how could such an important U.S. policy be made without regard to scientific evidence or without regard to the consequences on human life? We do environmental impact statements; why not human impact statements?

I think to answer this question you have to go back to the early 1970s and look at how DDT was banned. In 1972 there were 7 months of hearings by the Environmental Protection Agency on DDT before a hearing examiner, Edmund Sweeney. At the end of those 7 months and 9,000 pages of testimony, he ruled that DDT should not be banned based on the scientific evidence. He said, "DDT is not a carcinogenic, mutagenic or teratogenic hazard to man and does not have a deleterious effect on freshwater fish, estuarine organisms, wild birds or other wildlife." He also said it would be more harmful to ban it.

Yet, within a month after that, the EPA Administrator William Ruckelshaus banned it, and he said he did it for political reasons. He did this unilaterally.

For this reason and for the millions of lives that have been lost, particularly in the developing sector in Africa and Asia as a result of this ban on DDT, which was probably the most beneficial chemical man ever invented, I call DDT the "mother" of environmental hoaxes. I think now we have the "son of DDT" with a ban on CFCs and methyl bromide.

I have recounted this history because I really don't think we can afford to continue killing millions of people as a result of basing policies on political reasons, public perception, and not the scientific evidence.

[The prepared statement follows:]

TESTIMONY OF MARJORIE MAZEL HECHT
MANAGING EDITOR, 21ST CENTURY SCIENCE & TECHNOLOGY

Mr. Chairman and Committee Members:

I am Marjorie Mazel Hecht, representing 21st Century Science Associates, publishers of the magazine 21st Century Science & Technology and the book The Holes in the Ozone Scare: The Scientific Evidence That the Sky Isn't Falling.

We strongly oppose the proposal to add methyl bromide, HCFCs, and HBFCs to the list of taxable ozone-depleting chemicals in Code section 4682. The actual cost to the nation of such a tax would be crippling, when measured in food losses and economic losses, and it will NOT protect any lives. Indeed it will damage lives, here in the United States and worldwide.

The proposal of such a tax continues the unscientific flight-forward pattern that has become U.S. policy regarding ozone depletion. This is a policy based on public perception and hypothetical models, not scientific evidence. It is a policy pushed very hard by environmental organizations and some research groups, backed by millions of dollars from foundations and corporations. The alleged dangers of ozone depletion have been repeated so often by these groups and the media that they have come to be accepted as truth, without question.

In this testimony, I would like to raise the questions that I think committee members should address before continuing this ozone flight-forward. My perspective in this is to look at the consequences of the nation's policy on ozone depletion in terms of human lives--how many lives will be lost as a result of this policies. I am not a scientist, but a science writer and editor, and I have considered the evidence presented by many experienced scientists worldwide whose work does not often get printed in the popular press or even the scientific press because it it not "politically correct."

First, what is the worst case scenario if the ozone depletion theorists are correct? They say we will have a 10 percent ozone depletion within the next 50 years. What does that translate into in terms of the alleged increase in ultraviolet radiation reaching the Earth? It means an increase equivalent to that that you would receive if you moved 100 miles or so toward the Equator--in other words, from Washington, D.C. to Richmond, Virginia. When we put this to the inventor of the ozone depletion theory, Prof. F. Sherwood Rowland, he acknowledged that this was not something that he would worry about--moving 100 or so miles south.

Clearly this is not a crisis situation for most people but a trivial geographic move. Is such a worst-case ozone-depletion scenario worth the disruption of refrigeration worldwide and trillions of dollars of costs incurred by the ban on CFCs and now the ban on methyl bromide? I think not.

Second, has any increase in ultraviolet actually been measured? No, there is no trend of an increase. The most definitive study by U.S. researchers Scotto and Urban over more than a 12-year period showed no significant trend of increase in UV-B, while some stations showed decrease.

Third, is there significant scientific evidence to indicate that ozone depletion is a natural, seasonal, and cyclical phenomenon that seems to follow the sunspot cycle? Yes, there is. The renowned ozone scientist Gordon Dobson discovered low ozone levels in Antarctica in the 1950s. As his colleague Marcel Nicolet recently testified, they were so startled to find such low levels of ozone that they threw out all the readings below 250 dobson units. French researchers also found such low ozone levels in the 1950s, before the widespread use of CFCs. Today's computer models, based not on observations but on the conjectures of Rowland and Molina, cannot explain why there would be a so-called ozone hole in the 1950s.

Fourth, what about natural sources of chlorine? They admittedly dwarf the man-made sources: there are millions of tons of natural sources (seawater, volcanoes, etc.) but only a few thousand tons of man-made sources. But do natural sources of chlorine reach the stratosphere? Ozone depletion theorists assert that they do not. The evidence indicates that they do. For example, French volcanologist Haroun Tazieff pointed out in a recent interview that in Antartica the stratosphere is very low (5,000 meters) and the active volcano there, Mt. Erebus, is at a very high altitude (4,000 meters), so that the volcanic emissions indeed reach the stratosphere. Based on studies of the radioactive fallout from the Chernobyl accident, Zbigniew Jaworowski showed definitively that chlorine and other heavy elements do reach the stratosphere.

There are many more basic questions that could be asked about ozone depletion. I think at best one could say that the science here is uncertain. I would put it more boldly: the science is faulty and in some cases nonexistent. Why is this nation making a policy decision about ozone depletion based on uncertain science or faulty science when the consequences are so drastic? What is certain is that lives will be lost as supplies of the benign and cheap refrigerants are cut off and people here and in the rest of the world will not be able to afford the much more expensive replacements.

- Methyl Bromide -

Methyl bromide is an absolutely essential, ubiquitous, and benign fungicide and fumigant. It is used as a soil fumigant, increasing crop yields by up to 500%. It is also used in the storage and transportation of food, including grains, fruits, nuts, and vegetables to dramatically decrease losses from mold, bacteria, insects and other pests. The capacity to preserve food in a wholesome form until it gets to market is the hallmark of an industrialized nation. A tax on methyl bromide, an essential component of that capacity, will turn a nation from food self sufficiency to dependence on increasingly scare and unaffordable food imports.

Banning or taxing methyl bromide will not have any appreciable impact on the amount of methyl bromide in the atmosphere; 300,000 tons a year are produced by marine life in the oceans. Marine microorganisms, seaweed, and marine invertebrates use methylation to eliminate hazardous substances. In the process of methylation, they produce methyl bromide--thousands of tons of it yearly. Many swamp and bog organisms do the same thing, as do some land plants. Sea salt sprays throws 2,000,000 tons a year of bromide into the atmosphere; volcanoes throw an average of 78,000 more tons per year. The net result is that man's use of methyl bromide pales in comparison to natural source of bromide released in the atmosphere. Natural sources add 2,378,000 tons of bromide to the atmosphere per year, while halons, like methyl bromide, add only 12,040 tons per year.

Banning or taxing methyl bromide out of existence will exacerbate national and global food shortages. This food shortage, which will be hitting Americans in the form of increased food prices within weeks, was generated by disastrous weather here and internationally, coupled with collapsing economic conditions for farming. The process of cartelization of U.S. agriculture is driving many family farmers off the land and replacing them with huge agro-industry farms owned by the leading cartels that market grain and meat. As a result, much of the world is dependent on the very productive Midwest grain belt. The summer floods mean that not only are most of this year's crops lost, but the grain stored largely in that same area from last year's crops--our food reserves--are also largely lost.

Many other countries experienced comparable or worse weather catastrophes that add up to a global food shortage on a scale not seen for decades. Other agricultural areas in the United States have been hit with weather disasters--some from floods, some from droughts--and there are predictions of early frosts.

Where does this leave the issue of protecting the crops that are harvested under these food-scarce conditions? The reality is that in spite of the push to find substitutes, good economically realistic substitutes for methyl bromide do not exist. Phosphene can be replace some uses of methyl bromide, but this is far more toxic compound. Irradiation and controlled atmospheres could replace some uses of methyl bromide, but the infrastructural capacity does not exist to use these on a wide scale to reduce food spoilage--and it is not likely to be there soon.

Under these disastrous conditions, can Congress possibly afford to tax or ban methyl bromide, and thus allow a good percentage of what is harvested this fall to be wasted by spoilage?

- The Consequences in Terms of Human Lives -

We know that the human consequences of the ban on CFCs and the ban on methyl bromide were not even considered. In fact, 21st Century asked EPA administrator William Reilly at a press conference Nov. 12, 1992, whether the EPA had evaluated the consequences worldwide of a phaseout of methyl bromide. They had not! In other words, the EPA was making a decision based on uncertain science and they had not even bothered to assess the damage it would cause. (An hour earlier on Nov. 12, several environmental groups, including Friends of the Earth, the Natural Resources Defense Council, and a coalition of groups opposing methyl bromide held a press conference demanding that methyl bromide be banned. They also made no mention of the consequences of such a ban.)

How could it be that such an important U.S. policy is made without regard to scientific evidence or consequences to human life? One has to go back to the early 1970s to find the answer to this question. In 1972, under heavy pressure from environmental groups that were waging propaganda campaigns against DDT, the Environmental Protection Agency set up hearings on the effects of DDT. There were seven months of hearings before an EPA hearing examiner, Judge Edmund Sweeney, and scientists from both sides of the issue testified. Nine thousand pages of testimony were produced. The hearing examiner ruled, on the basis of the scientific evidence, that DDT should not be banned. He said "DDT is not a carcinogenic, mutagenic, or teratogenic hazard to man [and] does not have a deleterious effect on freshwater fish, estuarine organisms, wild birds, or other wildlife."

Despite this official decision, the EPA administrator, attorney William Ruckelshaus, unilaterally banned DDT, as of January 1973. Ruckelshaus never attended a day of the hearings and admitted that he never read the testimony. He also admitted that his decision was based on political reasons, not scientific evidence. As a result, millions of people, particularly people of color in Africa and Asia have lost their lives. And to this day one still hears and reads the same fallacious allegations about the harm of DDT that were disproved in the EPA's seven-month hearing in 1972.

I have recounted this DDT history because I think DDT was the "mother" of many environmental hoaxes over the past 20 years whose consequences kill people. In this sense, the ozone depletion theory is another "son of DDT," and its consequences will also kill people. That is what I would like this committee to consider.

Of course, there are many well-meaning people who do not know this history and who may be genuinely concerned about ozone depletion. But I think that the committee should also be aware that many of the promoters of the ozone-depletion theory are environmental extremists and Malthusians. Sherwood Rowland, for instance, signed something called the Morelia Declaration. His name was second on the list of signers in a one-third page ad that appeared twice in The New York Times. The last paragraph of this Morelia Declaration ad reads: "If the latter half of the 20th century has been marked by human liberation movements, the final decade of the second millennium will be characterized by liberation movements among species, so that one day we can attain genuine equality among all living things."

Such genuine equality of species--where human lives are treated as cheaply as blades of grass--is what we are moving toward by increasing the number of policies based on political perception, not scientific evidence. This is not a practice worthy of this nation--or of this committee.

Mr. JACOBS. I think we better suspend this for a moment. I have to cast a vote.

Mr. Dinegar, I will be right back.

[Recess.]

Mr. JACOBS. Mr. Dinegar, please proceed.

STATEMENT OF JAMES C. DINEGAR, VICE PRESIDENT, GOVERNMENT AND INDUSTRY AFFAIRS, BUILDING OWNERS AND MANAGERS ASSOCIATION INTERNATIONAL

Mr. DINEGAR. Good afternoon. My name is Jim Dinegar. I am here today to represent the interests of the commercial real estate industry, especially as they relate to air conditioning, its cost, and its impact on the environment.

Membership of the Building Owners and Managers Association International testifies that a tax on replacement refrigerants would present unanticipated problems. The proposal to apply an excise tax to hydrochlorofluorocarbons, HCFCs, stands to generate limited revenue at great expense. The expense comes as a result of penalizing refrigerant purchasers for doing the right thing to protect the ozone.

Presently CFCs are taxed as part of a program to discourage their use. Combined with the Clean Air Act's ban on production and the fines and penalties in place at EPA, the use of CFCs has gone down dramatically. In many instances, the only suitable, reasonable, and responsible alternative to CFC use is the replacement refrigerant HCFC.

Tax on this replacement would do nothing to limit its use since it is often the only alternative. The tax on HCFCs would do nothing to protect the ozone, since it is proposed to be equal to the tax presently in place on CFCs. The tax on HCFCs would, however, raise a few dollars from individuals who are already struggling to incur the costs of complying with the Clean Air Act's CFC provisions.

Our industry's shift away from CFCs has been dramatic, partly because of the tax, partly because of the Clean Air Act, and partly because it is just good for the environment. To assess a penalty upon those individuals looking to employ more ozone-friendly alternatives is counterproductive and unfair.

We are working alongside the chiller manufacturers and the chemical companies to identify and utilize safe and effective alternative refrigerants. As yet there are no approved alternatives except one, HFCs. It is only possible to use this refrigerant in certain chillers, and we are seeing its use increase significantly.

The problem remains, however, that some chillers can only use CFCs or HCFCs. This is by far the vast majority of existing chillers, and as these chillers are designed to last upwards of 30 years each, the proposed tax on HCFCs would put them in the position of being damned if they do and damned if they don't.

BOMA International encourages you to forego the short term financial gain in light of the long term loss to the environment.

Thank you.

[The prepared statement follows:]

TESTIMONY OF THE
BUILDING OWNERS AND MANAGERS ASSOCIATION (BOMA) INTERNATIONAL
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
HOUSE COMMITTEE ON WAYS AND MEANS

SEPTEMBER 23, 1993

Thank you for the opportunity to appear before this Subcommittee to express the interests of the Building Owners and Managers Association (BOMA) International members. My name is James Dinegar, and I am BOMA's Vice President of Government and Industry Affairs.

BOMA International is a dynamic federation of 98 local associations whose members own or manage over 5 billion square feet of commercial properties and facilities in North America. The membership -- composed of building owners, managers, developers, leasing professionals, facility managers, asset managers and the providers of goods and services -- collectively represents all facets of the commercial real estate industry.

The proposal to apply an excise tax to hydrochlorofluorocarbons (HCFCs) stands to generate limited revenue at great expense. The expense comes as a result of penalizing refrigerant purchasers for doing the right thing to protect the ozone.

Presently, CFCs are taxed as part of a program to discourage their use. Combined with the Clean Air Act's ban on production and the fines and penalties in place at EPA, the use of CFCs has gone down dramatically. In many instances, the only suitable, reasonable, and responsible alternative to CFC use is the replacement refrigerant, HCFC. Tax on this replacement would do nothing to limit the use, since it is often the only alternative. The tax on HCFCs would do nothing to protect the ozone, since it is proposed to be equal to the tax presently in place on CFCs. The tax on HCFCs would, however, raise a few dollars from individuals who are already struggling to incur the costs of complying with the Clean Air Act's CFC provisions.

Our industry's shift away from CFCs has been dramatic -- partly because of the tax, partly because of the Clean Air Act, and partly because it is just good for the environment. To assess a penalty upon those individuals looking to employ more ozone-friendly alternatives, is counterproductive and unfair. We are working alongside the chiller manufacturers and chemical companies to identify and utilize safe and effective alternative refrigerants. As yet, there are no approved alternatives -- except one: HFCs. It is only possible to use this refrigerant in certain chillers, and we are seeing its use increase significantly. The problem remains, however, that some chillers can only use CFCs or HCFCs This is by far the vast majority of existing chillers. As these chillers are designed to last upwards of thirty years each, the proposed tax on HCFCs puts them in the position of being "damned if they do, and damned if they don't."

BOMA International encourages you to forego the short-term financial gain, because of the long-term loss to the environment.

Building Owners and Managers Association International
1201 New York Avenue, NW, Suite 300
Washington, DC 20005
(202) 408-2684

Mr. JACOBS. Thank you, sir.

The next witness I believe is Mr. Sanner.

STATEMENT OF HARVEY JOE SANNER, EXECUTIVE VICE PRESIDENT, AMERICAN AGRICULTURE MOVEMENT, INC.

Mr. SANNER. Thank you, Mr. Chairman. It is good to be here today. I appreciate this opportunity for the American Agriculture Movement. I serve as executive vice president. We are a family farm organization. We represent family farmers and rural businesses.

We are here today in opposition to the proposed tax on methyl bromide because quite frankly the science is unclear at best, and on top of all the other things we have to contend with trying to make a living in farming, now we have to devote time and energy to a tax proposed by what we think are a bunch of narrow-minded bureaucrats in the Environmental Protection Agency. It is a necessary fumigant and it has been targeted by EPA, as I mentioned, without conclusive scientific evidence.

In fact, it is quite obvious—I think Chairman Rangel mentioned earlier before you came in, perhaps—that the science is unclear, that it would be premature to propose such a tax and even label methyl bromide as an ozone depleter. Besides, the benefits to the Treasury wouldn't be that great, but it would probably triple the cost to our farmers who are using it. And from a principle standpoint, it bothers us that we are seeing an arrogance from EPA in particular, and they continue to ignore the evidence and the testimony of hundreds who oppose their proposal.

Farmers, small business people, foreign governments, State and Federal agencies overwhelmingly have shown the necessity and benefits methyl bromide provides. Of the 517 responses to its proposed ban that EPA received, 464 opposed EPA. Farmers producing apples and grapes in New York, tobacco in Virginia and Tennessee, corn in Nebraska and Missouri, fruits and nuts in Oregon, and vegetables in California and Florida, and rice in Louisiana need methyl bromide.

EPA and some environmentalists still argue that it is not important, that alternatives are available and that it harms the ozone layer. Quite frankly, we think they are wrong on all three assumptions. They have suggested that it is unimportant, and even one EPA official went so far as to say that it was a fumigant used primarily with ornamental shrubs, turf, and luxury foods.

The fact is, Mr. Chairman, it is used on over 100 crops that are grown, stored, transported and processed in the United States, and unless EPA regards wheat, corn, tomatoes, and oranges and lettuce and apples as luxury foods, we don't really know what they do call luxury foods.

The U.S. Department of Agriculture has taken a strong exception to the EPA proposal, and we are quite grateful to Secretary Espy for taking this common sense approach. He recognizes it as being necessary to production of adequate quantities of food. It is essential to agricultural trade.

Federal law requires that most imported fruits, grains, timbers, flowers, and vegetables first be fumigated with methyl bromide before being allowed into the United States. More important to us as American farmers, many other nations have the same policy.

In June of last year, the director of the plant protection division of Japan's Ministry of Agriculture, Forestry and Fisheries wrote the Northwest Cherry Growers Association saying, "If methyl bromide is restricted, we will not be able to import U.S. cherries, walnuts, nectarines, et cetera. In addition, since we will not have any treatment for imported staple agricultural products such as wheat, corn, soybeans, et cetera, from the U.S., when insect pests are found appearing in an imported inspection in Japan, these infested shipments would have to either be destroyed or re-exported to your country."

So it is easy to see it is very important, and we have attached to our formal testimony copies of the 446 letters in opposition to EPA's proposal. I guess in plain language and with a lot of detail in these letters, you won't have any doubt recognizing the importance of EPA to the farm community.

Second, EPA and some environmentalists believe that there are alternatives available. Quite frankly, there are not. There are no alternatives available at this time. We would have to substitute as many as seven different chemicals on the farm to do the job that EPA does with no residue on food and no residue on soil, and we think that is two important traits that we shouldn't sacrifice in this country. So it is very important that we keep it, and maybe at some point in time there does need to be an alternative produced, but it is not available now.

There was a 3-day workshop that USDA conducted last year with over 100 distinguished scientists and many farmers to discuss methyl bromide and its alternatives, and the official report hasn't been distributed yet but the consensus was clear at that workshop, that it is very important that it should be kept on the market, and we should be allowed to keep using methyl bromide.

That yellow light makes me nervous. I know the red one is fixing to come on and the bell is going to follow that.

Mr. JACOBS. It is intended to make you nervous.

Mr. Douglas.

Mr. SANNER. I think I pretty well said everything that needs to be said before it did ring, people this morning pretty well said it, and Chairman Rangel pretty well agreed.

Mr. JACOBS. Now you are taking Mr. Douglas' time.

Mr. SANNER. I am sorry.

[The prepared statement follows:]

American Agriculture Movement, Inc.
America Needs Parity!
American Agriculture Movement, Inc.
100 Maryland Ave., N.E., Suite 500A, Box 69, Washington, D.C. 20002
(202) 544-5750

Remarks Before the Select Revenue Measures Subcommittee
of the Ways and Means Committee
of the United States House of Representatives

Harvey Joe Sanner
Executive Vice President
American Agriculture Movement

Tuesday, September 21, 1993

Mr. Chairman and Members of the Subcommittee, I am Harvey Joe Sanner and I live on and operate a family farm in Des Arc, Arkansas. I produce rice and soybeans and serve as the Executive Vice President of the American Agriculture Movement, Inc. AAM, is made up of 150,000 farm families in 34 states.

Increased farm income for family farmers is our primary reason for existing and maintaining an office in Washington, D.C. Basically, fairness is all we have ever asked for. We haven't had it in the recent past and too many of our farmers have been forced out of farming as a result. While working for fairness in the farm income arena we find ourselves devoting time to tax fairness for the farm community.

Our research proves that excise taxes fall unfairly on rural citizens. Because the items taxed have to be used more heavily and rural incomes are on average lower, so excise taxes take a larger share of our income.

Now we have to devote time and energy to a tax proposed by narrow minded bureaucrats in the Environmental Protection Agency. A necessary fumigant, methyl bromide, has been targeted by EPA for taxing and banning without scientific evidence to support their position.

The benefit to the treasury would not be that great, yet it would almost triple the cost to the farmer.

More importantly from a principle standpoint is the arrogance from a government agency that causes them to ignore evidence and the testimony of hundreds who oppose EPA's proposal. Farmers, small business, foreign governments, state and federal agencies overwhelmingly have shown the necessity and benefits methyl bromide provides. Of the 517 responses to its proposed ban that EPA received, 464 opposed EPA. Farmers producing apples and grapes in New York, tobacco in Virginia and Tennessee, corn in Nebraska and Missouri, fruit and nuts in Oregon and vegetables in California and Florida to rice in Louisiana, need methyl bromide.

EPA and some environmentalists still argue that methyl bromide is not important, that alternatives are available and that there is no doubt that methyl bromide harms the ozone layer. Because EPA is wrong on all three assumptions, we urge the Subcommittee to remove methyl bromide from the prospective tax list, at least until more is known.

Let us examine these three wrong assumptions.

First, EPA officials have suggested that methyl bromide is unimportant. Specifically, last year an EPA official was quoted as saying that methyl bromide is "a fumigant used primarily with ornamental shrubs, turf and luxury foods."

The fact is, Mr. Chairman, nearly 100 U.S. crops are grown, stored, transported and processed with methyl bromide. Unless the EPA regards wheat, corn, tomatoes, oranges, lettuce and apples as "luxury foods," we do not know where the Agency got its information.

The United States Department of Agriculture, which has taken strong exception to the EPA proposal, recognizes methyl bromide as essential to the production of adequate quantities of safe food.

Methyl bromide is essential to agricultural trade. Federal law requires that most imported fruits, grains, timber, flowers and vegetables first be fumigated with methyl bromide before being allowed in the U.S. More important to us, as American farmers, many other nations have the same policy. In June of last year, the director of the Plant Protection Division of Japan's Ministry of Agriculture, Forestry and Fisheries, wrote the Northwest Cherry Growers Association, saying,

> "If methyl bromide is restricted, we would not be able to import U.S. cherries, walnuts, nectarines, etc. In addition, since we will not have any treatment for imported staple agricultural products such as wheat, corn, soybeans, etc. from the U.S. when insect pests are found during an important inspection in Japan, these infested shipments would have to either be destroyed or re-exported to your country."

Is methyl bromide important? We have attached to our formal comments copies of the 464 letters in opposition to EPA's proposal. In plain language and considerable detail, those letters describe the importance of this vital fumigant.

Second, EPA and some environmentalists believe that there are, or will be, good alternatives available to farmers if methyl bromide is banned.

Again, Mr. Chairman, we do not know where the EPA gets its information. Just this past June, the United States Department of Agriculture conducted a three-day workshop attended by more than 100 distinguished scientists and many farmers. There was just one subject discussed -- alternatives to methyl bromide.

The official report from the workshop is not yet distributed but the clear consensus from that meeting was as follows:

1. There are no alternatives to methyl bromide for most uses. Of those that may exist, some -- for example, steam and organic farming -- are totally impractical except in very limited applications. Others -- for example -- irradiation -- are unacceptable politically.

2. Federal and some state authorities are removing other chemicals from the marketplace. Of the very few alternatives sometimes mentioned, many are suspected as cancer-causing. Others simply aren't approved for use with food crops.

3. It is almost impossible to get approvals for new agricultural fumigants.

Therefore, not only do we not have alternatives currently available but we have few prospects for any. What, in specific terms does this mean?

This one chemical -- methyl bromide -- protects plants from insects, viruses, rodents, nematodes, fungi and weeds. Theoretically, it could take as many as seven chemicals -- if they were available -- to have the same effect. Methyl bromide leaves no residue on food or soil and this is a feature that we should not sacrifice. Increased imports and exports of food with possible contamination is a risk we don't need.

Finally, the EPA and some environmentalists say there is no doubt that methyl bromide harms the ozone layer.

Mr. Chairman, I am not a scientist, I'm a farmer but I did learn how to read. Scientists at two other departments of the federal government the USDA and the Energy Department, each told the EPA that serious doubts exist about the case against methyl bromide.

Let me list just two of those doubts:

1. As much as 80 percent of methyl bromide comes naturally from the oceans and will continue doing so whether or not EPA bans this fumigant.

2. Scientists are not sure how much man-made methyl bromide even reaches the stratosphere or whether it is all in a form that harms the ozone layer.

The EPA says that methyl bromide has an ozone depletion potential number, or an ODP, of 0.7. An ODP is a reflection of how harmful a chemical is to the ozone layer. Under U.S. law, any ODP above 0.2 must be banned within seven years.

If scientists are unsure, how did EPA arrive at 0.7? They borrowed the number from the United Nations Environment Programme which itself admits that far more research is needed.

That research is now under way on a cooperative basis by the National Air and Space and Administration, the National Oceanographic and Atmospheric Administration and by the methyl bromide manufacturers. We are told that the first reports indicate that the ODP is far lower than 0.7 and could well be below the magic number, 0.2.

The United Nations decided to wait for real science before deciding what to do about methyl bromide.

We would ask this Subcommittee and the Congress to do the same. Whether or not EPA proceeds responsibly, we urge the Subcommittee to proceed with caution here.

A tax on methyl bromide will do far more than harm farmers. It will severely limit our ability to feed ourselves and the rest of the world.

Mr. Chairman, I can't tell you how many farmers will go out of business because of the taxes in the reconciliation bill. I can't tell you how many farmers would be hurt by this tax. But, Mr. Chairman, I know the number will be significant.

STATEMENT OF RICHARD DOUGLAS, SENIOR VICE PRESIDENT, SUN-DIAMOND GROWERS OF CALIFORNIA, ON BEHALF OF THE CROP PROTECTION COALTION

Mr. DOUGLAS. Thank you, Mr. Chairman.

I am Richard Douglas. I am senior vice president of Sun-Diamond Growers, an agricultural cooperative comprised of Sun Maid raisins, Diamond walnuts, Sun Sweet prunes, valley figs, and Oregon hazelnuts. I am here today to testify as a member of the executive committee of the Crop Protection Coalition which is a nationwide group of agricultural producers, handlers, and agricultural organizations who have joined together to meaningfully participate in the regulatory review of crucial crop protection tools used in the growing, harvesting, handling, storing, and transportation of agricultural commodities.

Mr. Chairman, the coalition opposes any proposed tax on methyl bromide for a number of reasons. I will attempt to summarize these quickly.

First, such a proposal is premature in the fact that EPA has not yet issued a final regulation under the Clean Air Act that concludes that methyl bromide is a class I ozone-depleting substance. The agency must first review the hundreds of comments that have been filed on this issue before making a final decision on the classification of the chemical.

Second, the tax is based on the ODP or the ozone depletion potential of the chemical. Clearly there is significant scientific uncertainty associated even with the EPA's proposed ODP of the chemical.

Third, the EPA has recognized that there is currently no substitute for a variety of agriculture uses for methyl bromide.

Fourth, the EPA proposed regulation, even if finally adopted, would phase out the use of methyl bromide by the year 2000. A tax would unreasonably increase the economic burden on small farmers during this phaseout period and would not serve any legitimate purpose. A tax would increase the cost of using the product for which no current alternative exists, and would put U.S. growers at a substantial competitive disadvantage in international trade.

It is important that the committee consider the entire methyl bromide issue in the world context, particularly how it is being addressed by the parties to the Montreal Protocol. The issue of the ODP of methyl bromide recently was considered at the fourth meeting of the parties to the Montreal Protocol in Copenhagen, Denmark.

Mr. Chairman, EPA's proposal goes significantly further than the world community has determined necessary on this issue. In the future, this will result in the United States being placed at a significant competitive disadvantage with its world competitors.

For example, U.S. exporters may be precluded from certain world markets because of the inability to address quarantine concerns of the country of import while our trade competitors will be able to address these concerns due to continued use of methyl bromide.

Additionally, the position of EPA on methyl bromide will negatively affect the ability of many foreign producers to export to the United States, again because of a similar inability to treat agricultural commodities to address quarantine concerns. This would also have a major foreign policy implication, one that concerns Chairman Rangel, and that is the exportation and the growing of illegal substances in developing countries.

At a time when we are encouraging farmers to move from producing illegal crops to crops that they can use for exports, we are going to not be able to import those products into the United States simply because they cannot meet quarantine requirements of the United States.

In conclusion, Mr. Chairman, the coalition believes that with methyl bromide the EPA is faced with a different type of chemical than it has been used to in dealing with under the Clean Air Act. The overwhelming contribution of methyl bromide to the atmosphere appears to appear through natural means.

There are significant scientific uncertainties associated with determining the actual ODP of methyl bromide which remain unresolved. The economic costs from the loss of this chemical would be enormous.

Just to give you one personal example, Mr. Chairman, 10 years ago I went to California; we could not export in-shell walnuts into the Japanese market. I spent the first 3 years in California negotiating, working with our government and the government of Japan to develop a protocol that would allow California walnut producers to export walnuts to Japan. The Japanese government required that California walnuts be fumigated with methyl bromide.

If we lose methyl bromide, if the cost becomes prohibitive for our farmers to use, we cannot export walnuts, cherries, apples, other agricultural products to Japan. This, Mr. Chairman, will certainly place our country at a competitive disadvantage because others will use methyl bromide and fill that void.

[The prepared statement follows:]

TESTIMONY OF RICHARD DOUGLAS
SENIOR VICE PRESIDENT, SUN-DIAMOND GROWERS
CROP PROTECTION COALITION

BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U. S. HOUSE OF REPRESENTATIVES

COMMENTS OF THE CROP PROTECTION COALITION IN RESPONSE TO THE PROPOSAL TO ADD METHYL BROMIDE TO THE LIST OF TAXABLE OZONE DEPLETING CHEMICALS IN CODE SECTION 4682

STATEMENT BY THE CROP PROTECTION COALITION

The Crop Protection Coalition (the "Coalition") is a nationwide group of agricultural producers, handlers and agricultural organizations who have joined together to meaningfully participate in the regulatory review of essential crop protection tools used in the growing, harvesting, handling, storing and transportation of agricultural commodities. The Coalition works with a variety of interests including industry, government and environmental organizations to assure that economically and technically feasible crop protection tools are available to address the significant needs of the food sector. Methyl bromide and its potential alternatives are among the tools of interest to the Coalition.

On March 18, 1993, the U.S. Environmental Protection Agency ("EPA") published a notice of proposed rulemaking concerning the Clean Air Act. Specifically, the Agency is proposing to list methyl bromide as a Class I substance with an ozone depleting potential ("ODP") of 0.7. It also is proposing a production freeze for the chemical at 1991 baseline levels, commencing January 1, 1994, and a total phaseout of methyl bromide by January 1, 2000. Further, the Agency is also proposing that when methyl bromide is used in an "agricultural process" i.e. the growing, harvesting, storing and transporting of foods such as fruits and vegetables, such foods would not be subject to the labeling requirements of section 611 of the Clear Air Act. 58 Fed. Reg. 15038. The Coalition has filed extensive comments on the proposal. In addition, there were several hundred other comments filed with the Agency concerning the proposed rule. All of these comments are before the Agency for its evaluation prior to taking any final action on the proposal.

The coalition opposes any proposal to tax methyl bromide for a number of reasons.

First, such a proposal is premature in that the EPA has not yet issued a final regulation under the Clean Act that concludes that methyl bromide is a Class I ozone depleting substance. The Agency must review the hundreds of comments that have been filed on this issue. Further, relevant scientific information continues to develop, almost on a daily basis, concerning the ozone depletion potential ("ODP") of methyl bromide. The Agency must review all the relevant information and must assure that all relevant data have been developed prior to making a final decision on the classification of the chemical.

Second, the tax is based on the ODP of the chemical. Clearly, there is significant uncertainty associated with even the EPA proposed ODP of the chemical. Because of the uncertainties, the ODP may range from well below 0.2 to well above 0.2. Consequently, in view of the substantial margin for error in current tentative ODP value for methyl bromide, a tax based on the ODP level is unreasonable.

Third, the EPA has recognized in the proposal noted that it is generally agreed that there is no current substitute for a variety of agricultural uses of methyl bromide. Significant efforts are underway to try to find alternative methods of application and/or an equally effective substitute. The House Committee on Appropriations report for fiscal year 1994 recognizes the critical importance of methyl bromide in agriculture. It states:

> "Methyl bromide -- For research on a replacement for methyl bromide, the Committee has provided $8,549,000, an increase of $1,000,000 above the budget request. Methyl bromide is used extensively by the agriculture industry. It is perhaps the most effective and important chemical available to protect a variety of crops from viruses, fungi, nematodes, and weeds. For many crops, viable alternatives are just not available.
>
> "In addition, methyl bromide is the agent of choice for the USDA's quarantine program. Further, many countries mandate fumigation with methyl bromide before permitting the importation of agricultural commodities. Mexico mandates methyl bromide fumigation for peaches, plums, and nectarines; and Japan mandates it for walnuts, cherries, and nectarines. Many other countries and crops could also be cited."

According to the USDA:

> "A total of 35 commodity listings from 128 countries are shown to require MB fumigation as a condition of entry. Of these, 17 have an alternative treatment presently approved -- and 25 have no alternative treatment. . . .
>
> "Without effective alternatives to methyl bromide, these markets for U.S. exports would be lost . . . Production of some crops may shift to other countries."

Fourth, the EPA's proposed regulation, even if finally adopted, would phase out the use of methyl bromide by January 1, 2000. A tax would unreasonably increase the economic burden on small growers during this phase out period and would not serve any legitimate purpose. A tax would increase the cost of using a product for which no current alternative exists and would put U.S. growers at a substantial competitive disadvantage in international trade.

I. BACKGROUND

It should be noted that there are two uses of methyl bromide which are very significant to this Nation's food industry including members of the Coalition. The first involves the use of the pesticide as a pre-plant soil fumigant. The chemical helps control significant pathogens, pests and weeds in the soil. The elimination of these plant pests and diseases assists in the production of various wholesome foodstuffs. This use represents the largest agricultural use of methyl bromide, based upon the quantity of the chemical that is used. If methyl bromide or a similar crop protection tool is not available, it will be extremely difficult, and for some crops almost impossible, to produce or market various commodities in an economically viable manner.

The other critical use of methyl bromide is as a post-harvest fumigant. Frequently, subsequent to harvest, agricultural commodities require treatment with methyl bromide to meet federal, state, or international regulatory requirements. Treatment may also be required by receiving customers to assure that the food complies with contract specifications for insect or rodent infestation. Unlike soil fumigation which involves injection of the chemical into the soil, post harvest use of the chemical involves exposure of the food in a fumigation chamber. Additionally, extensive research efforts in the past and still underway are attempting to identify modifications that can be made to fumigation chambers to help further reduce emissions. This includes, for example employing re-cycling technologies to eliminate the release of the chemical into the atmosphere. From the Coalition's perspective, if there is no release of methyl bromide into the atmosphere, then it would appear that a tax on the chemical for agricultural uses would not be warranted.

II. ALTERNATIVES TO METHYL BROMIDE

An in-depth review is underway by the U.S. Department of Agriculture, agricultural producers and chemical manufacturers concerning the status of alternatives to methyl bromide. The Coalition believes that for both the soil fumigation and post-harvest uses of the chemical, feasible alternatives do not exist. Research efforts are underway in the private sector to identify possible alternatives for the soil and chamber fumigation uses. However, because we are dealing both with a biological situation and a need for any alternative to proceed through the appropriate regulatory gauntlet prior to being commercially available, we are concerned that alternatives even for this use of the chemical will not be available for many years. Further, we must be certain that any potential alternative has acceptable efficacy and does not present an unreasonable risk to man or the environment. The Coalition is working with the EPA, U.S. Department of Agriculture and various pesticide manufacturers to help address this problem.

While a research effort is underway to address the soil fumigation uses of the chemical, there are similar efforts underway to identify possible alternatives to the post-harvest uses of methyl bromide. Overall, the amount of chemical sold for this use is very minor when compared to the soil fumigation use. Consequently, despite the importance of the chemical to the food industry, there is little likelihood that it will attract the resources necessary from the private sector to identify possible alternatives. The Coalition believes very strongly that the U.S. Department of Agriculture has an important role in this regard. The Department has the expertise and resources necessary to most effectively attempt to develop alternatives for the post harvest uses of the chemical. At this time, it cannot be assured that their research effort will be successful. As noted previously, it remains to be determined whether a safe and effective alternative treatment to methyl bromide for post harvest uses can be identified.

In that regard, the USDA recently completed a conference on possible alternative to methyl bromide. A report of that conference is expected to be issued shortly. At the conference, the lack of viable alternatives for many critical agricultural uses of methyl bromide became readily apparent. It is believed that the USDA report on the company will confirm this.

III. SCIENTIFIC UNCERTAINTIES CONCERNING METHYL BROMIDE

Regarding methyl bromide, there are strong concerns that significant scientific questions exist which may impact a determination of the ODP of the chemical. Consequently, the Coalition believes that it is premature for either the Agency or this Committee to make a final decision on the regulatory classification or taxation of methyl bromide, before these questions are addressed by actual reliable scientific data. These unanswered scientific questions include, for example:

1. A determination of the mean atmospheric quantity of methyl bromide.

2. A determination of how methyl bromide is removed from the atmosphere; i.e., are there any natural processes (sinks) which remove the chemical and if so, at what rate does this process occur?

3. What percentage of methyl bromide is converted to hydrogen bromine, a substance which apparently does not affect the ozone layer?

4. What is the actual lifetime of methyl bromide in the atmosphere?

5. The contribution of methyl bromide to the atmosphere from natural versus man-made sources.

6. The process by which methyl bromide, which is heavier than air, actually reaches the ozone layer from fumigation.

While the Coalition does not have sufficient scientific expertise to answer the above questions, it is understood that research is currently underway to develop the scientific data to address these issues. This effort involves the manufacturers of the chemical and various federal agencies such as the National Oceanic and Atmospheric Administration ("NOAA") and the National Aeronautics and Space Administration ("NASA"). The data are expected to be available within the next 30 months. Any imposition of a methyl bromide tax prior to evaluation of critical, relevant data to determine the ODP of the chemical would be unfair and unreasonable.

The gaps in the data set regarding methyl bromide vis-a-vis the effect on the ozone layer have been well documented. For example, in the report "Methyl Bromide And The Ozone Layer: A Summary of Current Understanding, June 22, 1992 by Daniel L. Albritton, NOAA and Robert T. Watson, NASA, the significant number of substantive uncertainties in the data get involving methyl bromide are highlighted. For example, the authors write:

> "There are major uncertainties in the budget of CH_3Br, (methyl bromide) including: (i) the absolute calibrations for CH_3Br measurements and the quantification of: (ii) natural sources; (iii) the fraction that escapes to the atmosphere when used as a fumigant, especially when used in pre-planting applications; and (iv) possible oceanic and terrestrial surface removal processes. The current best estimate of 25 ± 10% for the anthropogenic contribution to the observed atmospheric abundance of CH_3Br would be lower if there were to be major surface removal processes or if the fraction of anthropogenic production that is released to the atmosphere were to be smaller than presently eliminated. Id. at 1-2.
>
> Similarly, the authors note that:
>
> A major remaining uncertainty in the calculation of bromine-related ozone loss and ODPs is associated with quantification of the rate of formation of HBr in the stratosphere. Further study of the stratospheric reactions that can produce HBr and direct measurements of bromine reservoir species would better constrain the model-calculated partitioning of the brominated species. If the rate of HBr formation were to be greater than currently estimated, then the calculated ODP and BrO (hence ozone loss) would be lower. Although the upper range of the observed BrO would appear to be in conflict with a significant HBr source, the lack of definitive data for HBr and the large scatter in observed BrO make it

difficult to rule out this possibility. In addition, the value of the ODP would be lower if there were to be significant removal of CH_3Br by terrestrial or oceanic surfaces. Alternatively, if recent laboratory measurements indicating a faster rate of formation of HOBr (via BrO + HO_2) were to be correct, then the ODP would be larger. Id. at 3.

In order to develop an appropriate data base for methyl bromide, Drs. Albritton and Watson propose the following research activities in their report:

4.1 Human activities and methyl bromide abundances.

Global Abundances

- Recalibrate and intercompare the methods employed in current CH_3Br measurement programs to understand better the differences among the data sets.
- Synthesize the recalibrated data to provide an improved global picture of CH_3Br concentrations, including spatial gradients and temporal trends.
- Undertake additional measurements of CH_3Br to define better the interhemispheric gradient and the magnitude of the seasonal cycle, especially in the Southern Hemisphere, which will provide insight into the relative importance of natural and man-made sources.
- Measure vertical profiles of CH_3Br, in conjunction with CFC-11, over a broad range of latitudes and seasons to provide an improved determination of the abundance of CH_3Br in the stratosphere and its ODP.
- Encourage the inclusion of measurements of CH_3Br in global field campaigns and at existing atmospheric monitoring stations (e.g., Atmospheric Lifetime Experiment/Global Atmosphere Gas Experiment).

Man-Made Sources

- Continue the collection of data on the production and use of CH_3Br, including geographical distributions, and seek out unreported data to assure an improved data set.
- Carry out field and modeling studies to quantify better the emission factors for the major applications (e.g., pre-planting fumigation) and to identify the major controlling factors, which would improve the estimates of the contributions of human activities and aid the design of new application techniques.
- Investigate other possible sources; for example, those from the transportation sector, inadvertent industrial production, and biomass burning, to assess the completeness of the emission inventory.

Natural Sources and Sinks

- Conduct measurements of both CH_3Br and CH_3Cl concentrations in surface waters, as well as in the air immediately above, to explore how the CH_3Cl data set can provide insight into the oceanic source or sink of CH_3Br.

- Investigate the efficiency of different marine organisms (phytoplankton and algae) to produce CH_3Br and CH_3Cl.

- Carry out field measurements with gradient and enclosure methods of the atmospheric deposition of CH_3Br and CH_3Cl.

- Use the improving data set in budget analyses with a hierarchy of tropospheric models to improve the understanding of human contributions to the global CH_3Br abundances.

4.2 Impact of Bromine on the Ozone Layer

Laboratory studies

- Re-examine (i) the rate coefficients and product distribution (with an emphasis on the HBr generation channels) of the reactions of $BrO + HO_2$, $BrO + OH$, and $Br + HO_2$ (including their temperature dependence) to improve the understanding of bromine partitioning in the stratosphere and (ii) the $BRO + O_3$ reaction at atmospheric temperatures to obtain a more sensitive upper limit on the impact of this reaction for ozone loss. Also examine the possible heterogeneous reactions involving bromine species on PSC surfaces and sulfuric acid aerosols.

Observations

- Simultaneously measure concentrations of BrO, HO_2, and C1O at higher stratospheric altitudes, at least up to 25 km, to extend the knowledge of the ozone-depleting and related compounds to altitudes above those of the current data set. Further, a range of seasonal conditions should be investigated, including those in tropical regions.

- Investigate the possibilities for measuring the stratospheric concentrations of HBr, HOBr, $BrONO_2$, which are not currently available, but which are needed to test the understanding of these sink and reservoir species.

Model Applications

- Continue to develop and apply a hierarchy of models to simulate the response of ozone to CH_3Br, using updated input (e.g., reaction rate coefficients and emission rates), and interpret the new field data from recent polar ozone field campaigns.

- Model intercomparisons, particularly in connection with bromide species and their contribution to ozone loss at different altitudes, latitudes, and seasons are needed.

In view of the current state of the science on the ODP of methyl bromide, it is not reasonable to rely on such a soft ODP value as a means to tax the chemical. Once the relevant data has been collected and analyzed, an appropriate and reliable ODP for methyl bromide can be developed. Until such time, any discussion of a tax on methyl bromide on its ODP is unwarranted.

IV. METHYL BROMIDE UNDER THE MONTREAL PROTOCOL

It is important that the Committee consider the entire methyl bromide issue in the world context, particularly how it is being addressed by the parties to the Montreal Protocol. The issue of the ODP of methyl bromide recently was considered at the Fourth Meeting of the Parties to the Montreal Protocol in Copenhagen, Denmark. While the Parties did propose that an ODP of 0.7 be adopted for the chemical, no action was taken to eliminate its use. Consequently, the EPA's proposal goes significantly further than the world community has determined necessary on this issue. This will result in the United States being placed at a significant competitive disadvantage with its world competitors. For example, U.S. exporters may be precluded from certain world markets because of an inability to address quarantine concerns of the country of import, while our trade competitors will be able to address these concerns through the continued use of methyl bromide. Additionally, the position of the EPA on methyl bromide will negatively affect the ability of many foreign producers to export to the United States, again because of a similar inability to treat the agricultural commodity to address quarantine concerns. This will also have a major impact on the U.S. foreign policy, particularly as efforts are made to induce growers to switch their production practices from growing and exporting illegal controlled substances to growing legitimate crops. If those farmers attempting to make the transition are denied access to the U.S. market because of the inability to meet quarantine restrictions which may well result with the loss of methyl bromide, then this transition program will fail. Due to the generally higher returns resulting from the sales of foodstuffs in the United States, these foreign producers must have access to the U.S. market to encourage them to make the transition to growing legitimate crops. This Committee should consider this prior to imposing considering a tax burden.

V. CONCLUSION

In its proposal the EPA has recognized the vital importance of methyl bromide to the food industry, and the lack of alternatives to the chemical. The USDA has provided detailed economic data on the critical importance of the chemical.

In conclusion, the Coalition believes that with methyl bromide the EPA is faced with a different type of chemical than it has been used to dealing with under the Clean Air Act. The overwhelming contribution of methyl bromide to the atmosphere appears to occur through natural means. There are significant scientific uncertainties associated with determining the actual ODP of methyl bromide which remain unresolved. The societal impacts from the loss of the chemical are enormous, both domestically and internationally. The United States seems to be well far afield from the rest of the world community on this issue. In view of all the interests involved and the current state of the science, it is strongly recommended that no action be taken at this time by the Subcommittee to consider a tax.

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Mr. **Jacobs**. Thank you, Mr. Douglas. It might be nice if we could export some of our nuts. So that is the best argument.

The panel has made a very concise and consequently refreshing presentation. I, for one, understand the argument. It is strong, it is persuasive. We thank you all for your contribution.

Ms. Hecht, I wish you would go easy on Billy Ruckelshaus. By some coincidence he is the one who taught me to play football when we were in grade school together.

Ms. **Hecht**. Perhaps he is better at football.

Mr. **Jacobs**. Yeah, I mean that may be one of his failings now that I look back.

Thank you all for your contribution to the record.

Mr. **Jacobs**. We will call the fifth panel now. I assume everybody knows who he or she is. Mr. Maheu, Mr. Hinely, Mr. Pennell, and Mr. Lockhart.

I don't know if I am pronouncing it right, Mr. Maheu, you are first.

STATEMENT OF RONALD T. MAHEU, COCHAIRMAN, TECHNOLOGY, VENTURE CAPITAL, GRADUATION STRATEGY, COOPERS & LYBRAND

Mr. **Maheu**. Thank you. Would you like me to proceed?

Mr. **Jacobs**. For 5 uninterrupted minutes.

Mr. **Maheu**. Mr. Chairman, members of the committee, on behalf of Coopers & Lybrand, I appreciate the opportunity to provide our views on this matter.

As chairman of the Technology and Venture Capital Programs, I focus on matters that allow our high-technology companies to maintain and sustain marketplace advantages and eliminate or avoid factors that reduce or diminish our ability to compete for investment moneys, market share, or technology development leadership.

In deference to your time requirements, I will focus my remarks on four issues on your agenda and the impact that they would have on U.S. companies' abilities to compete in new technology. All are important. You should not infer any priority from the order in which they are presented in my testimony.

U.S. tax rules are particularly important for high-technology ventures because successful ventures find themselves subject to a full array of taxes early in their product life cycle. They frequently start competing globally even before they learn to spell "international." High-tech companies generally must compete globally to succeed. U.S. companies are already operating with the hindrance of one of the highest costs of capital in the industrial world. The four tax issues I will discuss all impact costs, and ultimately the cost of our capital.

The proposal to disallow stock options from the R&D tax credit calculations would handicap emerging and other high-technology companies that reward successful R&D based on successful project development performance. For many of these companies, capital is their most critical and expensive resource. The reduction of the R&D credit would further limit the capital available for innovative research. The lack of permanence of the U.S. R&D tax credit is already a tax and funding planning problem for these companies, because R&D requires substantial cash over a period of time longer than Congress has traditionally provided when extending the credit.

Removing selected wage expenses from the R&D credit calculation by denying the tax determined expense of certain options exacerbates the problem and discriminates against firms that have limited cash to fund R&D.

If Congress decides to enact any legislation regarding the treatment of options under the R&D credit rules, a far better alternative would be to make the R&D credit permanent and clarify that the W–2 related tax expense of qualified stock options should be treated as wages for purposes of the R&D credit calculation, thus encouraging more performance-based R&D and making available additional financing for startups and other high-technology companies.

The proposal to modify the export source rule would increase the cost to U.S. manufacturers who must find more markets for export. So long as the United States continues to run annual trade deficits, the United States should focus on finding incentives for U.S. companies to export more and increase global market share and create U.S. jobs rather than establish additional impediments.

The proposal to eliminate the U.S. foreign tax credit would handicap U.S. companies with one of the highest tax costs of any competitor in foreign markets. It would result in at least a triple tax on income, one by the foreign country, one by the United States at the corporate level, and the third level at the United States on the shareholder.

Many of our most successful U.S. companies must compete in foreign markets to succeed. With this handicap, they would have a distinct and substantial disadvantage, thereby encouraging future investments in other host countries with more favorable tax and investment environments.

In summary, the high-tech industries and their growth companies are important economic engines for the United States. The competitiveness of our tax laws is an important factor in determining their success.

Thank you, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY OF RICHARD T. MAHEU
COCHAIRMAN, TECHNOLOGY, VENTURE CAPITAL GRADUATION STRATEGY PRACTICE, COOPERS & LYBRAND

Mr. Chairman and Members of the Committee, on behalf of Coopers & Lybrand, I appreciate the opportunity to provide our views. In deference to your time requirements, I will focus my remarks on four issues that impact U.S. companies' ability to compete in new technologies. All are important; you should not infer any priority from the order of my testimony.

U.S. tax rules are particularly important for high-technology ventures because successful ventures find themselves subject to a full array of tax rules early in their first product life cycle -- they frequently start competing globally even before they learn to spell "international." High-tech companies generally must compete globally to thrive. U.S. companies are already operating with the hinderance of one of the highest costs of capital in the industrial world. The four tax issues I will discuss all impact costs and ultimately the cost of capital.

- The proposal to disallow stock options from R&D tax credit calculations would handicap emerging and other high-technology companies that reward successful R&D based on performance. For many of these companies, capital is their most critical and expensive resource. The reduction of the R&D credit would further limit the capital available for innovative research. The lack of permanence of the U.S. R&D tax credit is already a tax planning problem for these companies, because R&D requires substantial cash over a longer period of time than Congress has traditionally provided when extending the credit. Removing selected wage expenses from the R&D credit calculation by denying the tax determined expense of certain options exacerbates the problem and discriminates against firms that have limited cash to pay for R&D.

- If Congress decides to enact any legislation regarding the treatment of options under the R&D credit rules, a far better alternative would be to make the R&D credit permanent and clarify that the W-2 related tax expense of qualified stock options should be treated as wages for purposes of the R&D credit; thus encouraging more performance-based R&D and making available additional financing for startups and other high-technology companies.

- The proposal to modify the export source rule would increase the cost to U.S. manufacturers who must find more markets for export. So long as the U.S. continues to run annual trade deficits, the U.S. should focus on finding incentives for U.S. companies to export more and create U.S. jobs rather than impediments.

- The proposal to eliminate the U.S. foreign tax credit would handicap U.S. companies with one of the highest tax costs of any competitor in foreign markets. It would result in at least a triple tax on the income (one by the foreign country, one by the U.S. at the corporate level and one by the U.S. at the shareholder level). Many of our most successful U.S. companies must compete in foreign markets to succeed and, with this handicap, they would have a distinct and substantial disadvantage.

In summary, the high-tech industries and their growth companies are important economic engines for the U.S. The competitiveness of our tax laws will be an important factor in determining their success.

I. PROPOSAL TO EXCLUDE CERTAIN OPTIONS FROM THE R&D CREDIT -- NONQUALIFIED OPTIONS

The proposal to exclude stock options from the R&D tax credit calculation except to the extent that the employee recognizes income at the time the option is granted (a rare situation) would discriminate against new startups and other high-technology companies and would hamper our ability to compete on a global level.

Generally, the R&D tax credit rewards businesses for increasing certain technological research over research in prior years. In order to qualify, the process of experimentation utilized in the research must be one involving the evaluation of more than one alternative designed to achieve a result, where the means of achieving that result is uncertain at the outset; i.e., high risk. As a general rule, the single most significant expense of R&D is the wages associated with undertaking the R&D.

Under current law, it is clear that the amount paid for research under so-called "nonqualified employee stock option plans" is treated no different from other wages (W-2) for purposes of the R&D credit.[1] Under the nonqualified stock option rules, if the options provided to an employee for research have a readily ascertainable fair market value when issued, that value is taxable to the employee and deductible to the corporation when the option is issued. In the case of high-technology ventures, when options are issued, they generally do not have a readily ascertainable fair market value under the appropriate tax regulations, in which case the employee does not recognize income until the option is exercised. The income recognized when the option is exercised is the difference between the fair market value of the stock acquired and any amount paid by the employee for the stock. The corporation takes a corresponding deduction for the compensation at the same time.

Treating the option related tax expense more harshly than other W-2 wage income would discriminate against high-technology companies -- stock options are an important element of their employee recruitment and retention packages. New ventures are often unable to compete with the cash offered by other employers in their industries. Instead they offer employees a share in future appreciation resulting from successful R&D projects. If denied the R&D credit for option compensation, the technology ventures will be less competitive relative to foreign entities.

New high-tech ventures currently have difficulty planning R&D, because the research generally takes longer than the traditional periods of temporary extension that Congress has provided the R&D tax credit.[2] If Congress were to reach back now and deny R&D credits for the W-2 wage expense that relates to options, the value of Congress's commitment to an effective R&D credit will be diminished even further.

Denying the R&D credit for the W-2 tax expense related to options would complicate companies' tax filings, as well as increase the tax burden associated with past, current and future ventures. Such a policy change would also appear to be inconsistent with the preference that Congress demonstrated in OBRA '93 for performance-based corporate compensation arrangements.

II. CLARIFICATION FOR QUALIFIED STOCK OPTIONS

Even though the IRS acquiesced to the inclusion of nonqualified options in the R&D "wage" calculation, our experience is that IRS agents frequently attempt to disallow from the R&D credit calculation the W-2 tax expense of "qualified stock options," a term which I am using to include incentive stock options (ISO) under section 422 and discounted stock options under section 423 (section 423 plans).

For qualified stock options, no income is generated to the recipient upon the grant of an option. Upon exercise of the option, no taxable income will result if certain requirements are met, such as the requirement that the taxpayer must hold the stock for at least two years from the date of option grant and one year from the date of stock transfer. However, if the stock is disposed of prematurely, the tax rules are similar to those for nonqualified options.

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[1] Apple Computer, Inc. v. Commissioner, 98 T.C. 232 (1992) to which the IRS has acquiesced.

[2] OBRA '93 extended the R&D credit through June 30, 1995.

The amount of the employee's income (and the deduction for the company) is the difference between the value of the shares at the time of exercise and the amount paid for the shares.

The determining factor for whether compensation from a qualified option is considered for purposes of calculating the R&D research credit should be whether the taxable amount resulting from disqualifying dispositions is "wages" under IRC Sec. 3401(a) upon exercise. The definitions of income under IRC Sec. 61 and of "wages" under IRC Sec. 3401(a) are not identical, and that can leave room for some ambiguity.

The plain language of section 3401(a) supports the proposition that such amounts are included within the definition of wages. It defines wages as "all remuneration ... for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash...."[3] That the IRS does not require withholding on such amounts should not be determinative of their character. Rev. Rul. 71-52 does not require withholding, presumably as a matter of administrative discretion. The 1983 amendments to the FICA and FUTA tax statutes suggest that the IRS revisit this procedure at least as to the applicability of withholding to FICA and FUTA taxes, but to date it has not done so.

Clarifying that the W-2 tax expense of qualified stock options is treated as wages for purposes of the R&D credit would serve two significant tax policy objectives of the Ways & Means Committee. It would simplify the tax code by removing a potential controversy between the IRS and taxpayers, and it would clarify Congress's continued support for high-technology ventures.

III. EXPORT SOURCE RULE

The proposal to modify the export source rule when U.S. produced inventory is sold abroad would increase the cost for U.S. companies that must find more foreign markets for U.S. products. As long as the U.S. continues to run annual trade deficits, we should be looking for incentives to increase exports, not for tax changes that increase the cost of U.S. exports.

Under current Treasury regulations, when U.S.-manufactured property is sold abroad, the amount of income from the sale that is treated as foreign source for purposes of calculating the amount of foreign tax that is creditable against the seller's U.S. tax is generally determined as follows:

- 50% of the income from the sale is apportioned between the U.S. and foreign sources based on location of the U.S. company's production assets.
- 50% of the income is sourced based on the place of sale (which is generally where the title to the property passes).

The proposal described in the Joint Committee on Taxation print would modify this computation by sourcing more income to the U.S. when property is exported, thus increasing the relative cost of exports. The proposed changes would penalize those companies that manufacture in the U.S. and have a large investment in foreign marketing operations. It is quite discouraging that the change would encourage companies that want to pay no more than the U.S. tax rate on their worldwide income to move production facilities out of the U.S.

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[3] The regulations also support this proposition as they provide that all remuneration for services is included in the definition of wages unless specifically exempted by statute, even if the employer/employee relationship no longer exists, Sec. 31.3401(a)-1(a)(5); and that remuneration may be paid in stock, Sec. 31.3401(a)-1(a)(4). The regulations further provide that it is immaterial that payment is made in a form other than cash. Sec. 31.3402(a)-1(c).

If Congress decides to review the cost effectiveness of the sourcing rules as an export incentive, it should be undertaken only as part of an overall review of how the U.S. taxes multinational income and the impact any tax changes would have on U.S. competitiveness and our long-term trade balance.

IV. FOREIGN TAX CREDIT

I am incredulous that this issue is seriously being considered, but since it is on the list to be commented on, I feel compelled to join the ranks of severe critics on behalf of the high-tech industries.

The proposal to repeal the foreign tax credit and merely provide a deduction against U.S. taxes for foreign taxes paid would assure that U.S. companies could only compete abroad under the worst confiscatory tax rules in the industrialized world. Generally, income taxed abroad would be taxed at least once under the foreign country's tax rules, and then whatever is left would be taxed again under the U.S. tax system -- once at the corporate level and again at the shareholder level. Quite simply, U.S. companies would be unable to do business in most parts of the world, because the corporate level tax burden alone would be increased to a 50-60 percent rate in most instances (70-80 percent in some cases). They could not gain sufficient market share under that type of a tax structure and thus could not compete.

If the proponents of the foreign tax credit repeal believe that it would encourage more U.S. companies to stop doing business abroad, that is correct. But the result will also be less business and employment in the U.S. For example, in the computer field, any significant large scale integrated circuit must be marketed worldwide in order to achieve sufficient market share to recoup the significant investment in capital and R&D. Only foreign companies would be left with the ability to compete globally, i.e., companies that develop technology abroad, manufacture abroad, and market their products worldwide from a foriegn base.

I cannot recall any similar tax constraint placed on business. If the international financial markets interpreted a hearing on this subject as even a potentially serious threat, which they do not, you would not have to wait until date of enactment to see the impact. The flight of capital out of the U.S. would be substantial and therefore raise our cost of capital even higher.

Like many of the other revenue-raising proposals under consideration in this hearing, we believe that a review of the foreign tax credit rules should only be undertaken in the context of a more serious review by Congress on the broader issues of tax simplification and an effort to fashion tax rules that make U.S. companies more competitive in a global market.

Mr. JACOBS. Mr. Hinely.

STATEMENT OF J. VERNON HINELY, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CARBONIC INDUSTRIES CORP., ORLANDO, FLA.

Mr. HINELY. Thank you, Mr. Chairman.

I am J. Vernon Hinely, president and CEO and founder of this company. We are in the carbon dioxide business and have been for 30 years. I want to express my appreciation for this opportunity and privilege to present our views at this time, which I have come here with a great sense of, in fact, desperation, if you will, because I feel a problem that we have facing our industry is very devastating. And I know it is unintentional by the Congress to pass this tax bill giving a subsidy of course and it didn't know the full impact it would have on another industry completely.

This situation has deteriorated decisively in the last three or four years. In fact, my good friend here from Carbonaire in New York, he was forced out of business to sell his company three years ago because he could not compete against this unfair subsidy.

My company makes carbon dioxide, manufactures and distributes it. We sell CO_2, that is the carbonation, the freezing and chilling, water treatment, et cetera, et cetera. Our source—the crux of my problem is we do not make, develop the raw gas; it comes from a byproduct. We are downstream, if you will, or the tail on the dog of anhydrous ammonia or fermentation, ethanol, methanol, et cetera, so on. OK. We do not control that primary source, and we put a lot of money in the plants.

The last plant I built in Terre Haute, an ammonia plant in 1985, it ran 11 months, spent $2.5 million. It is still there sitting on my books at $1 million dollars. I don't control that.

What has happened here in the last 4 or 5 years, the Congress has given the producers, ethanol producers a subsidy. You know what it is, 54 cents a gallon. I am not here to quarrel about that subsidy. If the Government is giving the farmers help, that is fine, that is one thing, but double-dipping is another thing. The ethanol producers now have control of the primary source, the ethanol plant. From the ethanol plant they are getting free carbon dioxide. I don't have that luxury. My industry doesn't have it, or my company. We are being jeopardized. In fact, like I say, it is wreaking havoc.

I cannot compete with these kind of things when they are getting a free product. Like I say, this has been harmful, and the President spoke last night about the American dream. I guess I had a dream 46 years ago when I got out of the service and went into business and went to Orlando. My operation is from Miami to Landover. I have five dry ice plants, but I cannot continue. I am going to find myself in the same predicament of Mr. Julius Rubin back here in Carbonaire who was forced to sell.

All we are seeking is some kind of a fairness, a sense of fairness and justice in the form of a tax. We are asking that the ethanol makers who are getting the subsidy to make one product can't double dip and then take a free product and go out to the marketplace and cut my prices $30 and $40 a ton. That is what is going on. We are asking for a minimum of $15 surcharge tax on the ethanol makers that produce carbon dioxide and are selling it. Like I say, they are getting the tax money one way already, they are getting a break. It is totally unfair.

We just think that some remedy—it is easy to remedy it. The Treasury Department said, Well, how can they keep up with something like this. My goodness, at the end of the year, how do they keep up with tax returns? I report so much revenue and income. A producer of ethanol could say, "Well, we produced and sold 160,000 tons of CO_2, OK, $15 times that is the tax."

We are not coming here asking for a handout. I haven't asked any quarters in 46 years in business. The only thing I got from Uncle Sam when I was discharged in 1946 was the "52–20" and if you go into business, you get equal to that instead of being an employee. That is all I have gotten. I have paid my taxes. I have got 200 employees. I have got my insurance.

All this fuss about health insurance, it costs me a million and a half dollars a year. My employees have major medical, have been covered for at least 25, 30 years. But I wish in the sense of fairness that somebody—and I talked to Mr. Gibbons—we are trying to get to anybody we can. We are not asking for any quarters, we are not asking for any tax credit, we are just seeking fairness, is all, so I can continue to exist in business and my family.

This filters down even to my distributors. I have two sons—that light does make you nervous.

Mr. JACOBS. It is working.

Mr. HINELY. I have two sons in the cylinder gas business, the fountain that they serve is the mom and pop deal, you know, fountain service where you get your drinks. They can't even compete against these other distributors where they are buying CO_2 so cheap. So it is having a filter-down effect, the cancerous, the roots of this thing, the tentacles are far-reaching.

I just think that if we can enlighten Congress to sit down and realize what is happening, they would take a good look at this and try to correct it. The complexities of the tax or something, that is minor to what it has caused my industry and to me because I just don't believe my government, I didn't have any idea in 46 years being in business, that my government would be a threat to my survival in business. As a man of 69 years old, I should be out worrying about fishing down in the lakes of Florida somewhere instead of up here fighting for my very business survival.

The whole industry is in the same situation. That is the bottom line. The facts are on a seven-page thing over there on the table for the Congress. I have talked about this.

I appreciate your consideration and I beseech and plead with the Congress to do something about this situation in the sense of fairness.

Thank you, Mr. Chairman.

[The prepared statement follows:]

Testimony of J. Vernon Hinely
Chairman and Chief Executive Officer
Carbonic Industries Corporation
Orlando, Florida

Before the Subcommittee on Select Revenue Measures
of the Committee on Ways and Means
United States House of Representatives
September 23, 1993

REGARDING THE UNINTENDED AND THREATENING EFFECTS OF ETHANOL SUBSIDIES ON THE CARBON DIOXIDE INDUSTRY

First of all, I want to thank the Honorable Charles B. Rangel, Chairman and all members of the subcommittee for the opportunity and privilege of presenting the facts regarding a problem that is plaguing my company and the entire carbon dioxide industry. I feel a tremendous sense of responsibility as I stand before this group conveying the very critical nature and seriousness of a great and on-going injustice which has far-reaching consequences. In fact, it is with a sense of desperation that I approach this distinguished body which is a last hope to save my company and others in my industry. I hope and pray that my honest and heartfelt entreaty will forcefully and convincingly communicate the gravity of this matter.

Carbonic Industries is in the business of manufacturing and distributing liquid carbon dioxide ("CO_2"). Today I would like to specifically address the devastating effect that tax subsidies to ethyl alcohol (ethanol) producers are having on my company and my industry. These subsidies have created an unfair and unexpected advantage to ethanol producers who also produce liquid carbon dioxide.

This unfair advantage exists only because of these subsidies. The long-term effect of this problem, if left unchecked, will most certainly be the demise of a competitive CO_2 industry. And, in the process, companies like mine are actually being driven out of business.

I want to begin by giving you some insight by explaining the elements and factors that drive the economics of this industry. It is absolutely imperative, I repeat IMPERATIVE that you understand the supply side of our business.

Over the years, our industry has relied on by-product sources for its supply of raw, crude CO_2. We typically seek out companies that are producing CO_2 as a by-product (which is being or otherwise would be, vented to the atmosphere). We contract to purchase this gas "over-the-fence" for the production of food-grade CO_2. Principally CO_2 is a by-product in the production of anhydrous ammonia, hydrogen, ethylene oxide and ethyl alcohol (ethanol).

From this, two things become obvious. First, we have little choice of plant sites and, as a result, transportation expense becomes a major cost component. Second, we cannot ever be assured that any CO_2 plant will run for 10 years, 5 years or even 1 year. Since the inception of our business in 1965, eight of the twelve plants that we built were permanently closed due to the loss of by-product sources from up-stream plant closures.

Our most recent plant closure occurred in Terre Haute, Indiana. This plant cost $2.5 million and was closed in 1986 after only 11 months of operation. These idle assets created a major financial drain to my company for several years. We are just now removing this plant in the hopes of using it at another proposed site (which is dependent upon our successfully negotiating a contract for a by-product raw CO_2 source).

As a by-product industry, we have little control over the supply side of our business in terms of sufficiency of supply, logistics and the cost of raw CO_2.

Over the past thirty years, the principal by-product source for CO_2 has been the anhydrous ammonia industry (anhydrous ammonia is a liquid fertilizer used extensively in agriculture). In the mid-1970's domestic ammonia producers were forced, by government action, to compete with very low-priced foreign ammonia. Shiploads of ammonia were laid down in our seaports at a cost that was lower than our domestic ammonia producers' incremental cost for the feed stock (natural gas).

This wreaked havoc in the U.S. fertilizer industry (producers of nitrogen compounds including ammonia) and 20 to 25 plants were closed within a ten year span beginning in 1976. This had a domino effect on the CO_2 industry since ammonia production was the primary source for my industry.

These plant closures prompted my industry to diversify its CO_2 sources, albeit at a much higher cost. As a result, ethanol and acid neutralization sources were developed as well as natural underground CO_2 reserves. This was the backdrop of conditions as the ethanol industry entered the food-grade liquid CO_2 market a little over a decade ago.

The manufacturers of ethanol (which is used to produce gasohol) are being heavily subsidized by the United States government. It is impossible for anyone outside the ethanol industry to put a dollar figure on the total value of the many ways in which ethanol is advantaged in the law -- or even to know about all the incentives they have won, for that matter. This subcommittee is in a much better position than I am to say what that number is, but I think anyone would agree that it is enormous by any definition.

These subsidies have been legislated for purposes of assisting agriculture, development of alternate fuels, and the implementation of the Clean Air Act. Without the subsidies, the ethanol industry as we know it today could not exist in a free market system.

As I indicated earlier, carbon dioxide is a by-product in the production of ethanol (fermentation process). The incremental costs of converting raw carbon dioxide to a food-grade liquid by an ethanol producer can be minimal. One ethanol producer manufactures its own electrical power and has gone on record as stating that its liquid carbon dioxide is "free".

I can readily understand how ethanol producers might view their cost of producing liquid carbon dioxide as being "free". First of all, they are receiving $.54 per gallon in subsidies for every gallon of fuel ethanol that is mixed with gasoline to produce gasohol. This is a guaranteed revenue stream, a luxury we do not enjoy. Next, they have no worries of losing their CO_2 source since they will have CO_2 for as long as they produce ethanol (which production is guaranteed by the subsidies). And finally, their CO_2 is a waste product that need not be captured and sold in order for them to generate a profit so long as the subsidies are being received.

The ethanol industry, which controls a major primary source of raw CO_2, is now using its government subsidized cost advantage to carry out one of the most vigorous and widespread cost cutting campaigns in the history of the U.S. CO_2 industry in an attempt to also control the market for finished liquid carbon dioxide.

There is evidence that the ethanol industry is combining the distribution and marketing functions of carbon dioxide and fructose (corn sweetener), which is also produced by the ethanol industry, for an additional advantage over our industry, i.e., combined rail rates/shipments and common railhead truck depots.

In fact, some of our customers have indicated that they have been pressured by their fructose supplier to buy their carbon dioxide as well.

Approximately a month and a half ago, we lost our CO_2 business at two sizable soft drink bottling plants to an ethanol producer. This is business which we have enjoyed for over a quarter century. We are simply not able to sell CO_2 at the low prices being quoted by the ethanol industry throughout our marketing area.

Equally alarming is the filter-down effect this ill-advised subsidy is having on many of our distributors. These distributors are typically small "mom and pop" operations. They sell carbon dioxide in cylinders and mini-bulk tanks to fast food chains and convenience stores to carbonate fountain drinks. We have been told by many of these small companies that competing distributors for the ethanol industry have such a tremendous price advantage, many are being forced to sell their businesses to these competing distributors. You can see from this the extent to which the roots of this tax-supported malignancy are imbedded.

If this situation is allowed to continue unchecked, I predict that the ethanol industry will soon have a monopoly on CO_2. If this is permitted to happen, the ultimate result could be higher prices to all consumers of CO_2 without the checks and balances of unobstructed free trade.

This issue obviously stirs my emotions. My company supports approximately 200 families and approximately 250 other families own stock in the company and depend on it for income.

It is not unreasonable to believe that my company could be driven out of business in the same manner that my good friend Julius Rubin's company (Carbonaire, Inc., Palmerton, PA) was driven out of the CO_2 business about three years ago. He is also present and would be more than happy to explain to any interested listener how the unfair practices mentioned earlier were responsible for the demise of his business.

Moreover, the entire CO_2 industry, which is a half-a-billion dollar industry, supports an estimated 4,000 families in all corners of this nation (and countless stockholders) whose lives will be adversely and irreversibly affected if this blight isn't quickly brought under control.

When I returned home from World War II after serving three years in the United States Armed Forces in New Guinea, the Philippines, and Japan, I never doubted that I could achieve success as an entrepreneur. The ideals of my government and our democracy were of great comfort to me as I invested my life and money in a harmonious and free enterprise system. Now, however, I feel betrayed by the establishment that I had come to rely upon for nearly a half century.

I still have faith, although somewhat shaken (by the failure to achieve relief during the recent conference on the budget), that good people like you will, through whatever means or methods it might take, alter the rules to the extent that what is right will prevail. After thirty years in this business, wouldn't it be a paradox, and contrary to the great American system, for a small company such as ours to be forced out of business in this way. Yes, forced out of business by giant corporations who are enabled to engage in unfair practices solely because they are beneficiaries of hundreds of millions of dollars in subsidies.

IN CLOSING, I know that our honorable legislators did not realize these subsidies would permit the abusive practices now decimating our industry. Certainly, no one can argue that it was an intended result of the ethanol subsidy program to disrupt the CO_2 market. Nevertheless, the fact remains that a great travesty of justice exists in the form of governmental interference of the free enterprise system. Clearly it is discouraging and stifling American entrepreneurs and the business climate in which they function.

We are not here to ask for tax money or handouts. To my knowledge, which is pretty deep after 30 years in the business, my industry has never asked the government for any tax break or any subsidy. We are pleading with you to equalize the competitive playing field by working with us to find some way to offset or otherwise "undo" the damage the ethanol program has done to us.

Whether the remedy is an excise tax on CO_2 sold by ethanol producers -- which is one formulation we have proposed -- or some other solution, we believe that "where there's a will there's a way" that is fair and enforceable.

Finding and enacting that remedy would return the business prospects of my company and others in the CO_2 industry to the proper hands -- namely, our business skills, our hard work, and regular market forces. I might add that it would also raise some revenue which you could put toward deficit reduction or some other good use.

Thank you very much for the time and consideration you have given to me and our industry. I trust and pray that you will respond in a way which will rectify this great injustice.

At this point I would be more than happy to answer any questions you may have.

J. Vernon Hinely
Chairman & CEO
Carbonic Industries Corporation

September 23, 1993

Mr. JACOBS. Bravo.
Mr. Lockhart.

STATEMENT OF JAMES H. LOCKHART, VICE PRESIDENT AND GENERAL COUNSEL, THE BAPTIST FOUNDATION OF OKLAHOMA

Mr. LOCKHART. Yes, sir. Thank you, Mr. Chairman.

My name is Jim Lockhart. I am the vice president and general counsel of the Baptist Foundation of Oklahoma. I appear here today on behalf of the Baptist Foundations of Oklahoma, Texas, and Louisiana, also Maryville University, the Sierra Club, the University of Arkansas and the National Society of Fund-Raising Executives to urge this subcommittee's favorable consideration of a measure to correct two minor defects in the generation-skipping transfer tax law which unintentionally operate to discourage charitable giving.

The Baptist Foundation of Oklahoma receives and administers gifts for Southern Baptist churches, ministries, agencies, and institutions in Oklahoma and elsewhere. Last year, for example, we distributed over $1 million for housing, care, counseling and assistance to needy children, providing help to some 10,000 youngsters. We hold and help fund seven retirement centers and we also provide funding for Oklahoma Baptist University.

Through the Southern Baptist convention, we are able to help charitable and other ministries throughout the United States and the world. To support the work of our agencies and institutions, we depend upon the support of many donors. By far the largest source are thousands of small gifts, but there are in some cases very substantial gifts.

I work with these donors on a daily basis. I understand many of the considerations that go into their mind in making these gifts. Based upon my actual experience, I can tell you that these two defects which I will talk to you about hurt charitable giving.

First, I would like to say that we never claimed that the sole or even principal motivation for charitable giving is tax treatment. The churches and ministries that our people support were beneficiaries of charitable gifts long before philanthropy was recognized in the Tax Code. Nevertheless, in my experience, while the tax law may not affect an individual's initial desire to give, it does often affect the size of the gift when it is made, especially in cases of larger gifts through an estate plan.

For this reason, we should always make sure that the tax law does not discourage charitable giving where not necessary to advance tax policy. Unfortunately, this type of disincentive exists in a little known part of the generation-skipping transfer tax.

The generation-skipping transfer tax is an extra tax designed to eliminate the advantage of skipping a generation in a gift or bequest, for example, by transferring property instead of to a child directly to a grandchild. An important exclusion in the generation-skipping transfer tax provides that if a donor's child is deceased at the time of the transfer, then a gift to that child's children, in other words, the donor's grandchildren, will not bear generation-skipping transfer tax.

With this predeceased parent exclusion, Congress recognized that because the child was dead and not being skipped for tax avoidance reasons, it would be unfair to add a generation-skipping transfer tax on top of an estate or gift tax. This problem is significant because combined application of gift, estate, and other transfer taxes with a generation-skipping transfer tax, in some cases, operates to take 80 percent of the value of the gift.

The language of the predeceased parent exclusion, however, is unfairly restrictive in two respects. First, the exclusion is limited to the donor's lineal descendants, grandchildren only. For example, a donor who outlives his spouse, his brothers and sisters, his nieces and nephews, and wishes to make a gift to his or her grandnieces or grandnephews, the donor's only living relatives will bear the tax even though there is clearly no attempt of tax avoidance. Any individual facing this very high level of taxation on his or her estate almost certainly will reduce the charitable gift in order to make up for the additional tax and provide for his or her family.

Second, the exclusion only applies to direct gifts to those grandchildren whose parents have died. It does not apply to any type of transfer through a trust, including the very common type of trust that provides income to a charity for a period of years and then leaves the principal to the grandchildren.

These charitable trusts are very, very important to the work of the Baptist Foundation of Oklahoma, the other Baptist Foundations, and the other charitable organizations we represent. Many of our gifts are through charitable trusts.

Under the generation-skipping transfer tax, so long as the intervening ancestor is deceased at the time of the transfer, there is no reason of tax policy to treat these trust gifts different from direct gifts, yet by doing so charitable giving is unnecessarily discouraged. Having carefully reviewed these provisions and the anomalies they produce, we are confident the Congress could not have intended these results.

The Baptist Foundation of Oklahoma and the other organizations I represent here today urge Congress to amend the generation-skipping transfer tax statute to correct these problems. We believe that if such changes are made, it will help support charitable endeavors of all kinds, while ensuring that the policy behind the generation-skipping transfer tax is maintained.

Included with my written statement is suggested language to accomplish these changes, along with the more detailed explanation of how the proposed language will accomplish these objectives.

We thank you very much on behalf of the Baptist Foundation for this opportunity to testify. Thank you.

[The prepared statement follows:]

THE BAPTIST FOUNDATION
of Oklahoma

JAMES H. LOCKHART
Vice President and General Counsel

STATEMENT OF JAMES H. LOCKHART
Vice President and General Counsel
The Baptist Foundation of Oklahoma
3800 North May Avenue
Oklahoma City, Oklahoma 73112-6506
(405) 949-9500

Testimony In Support of Changes in the Predeceased Parent Exclusion to the Generation-Skipping Transfer Tax

Before the Subcommittee on Select Revenue Measures
Committee on Ways & Means
United States House of Representatives
Hearings on Miscellaneous Revenue Issues

September 23, 1993

MR. CHAIRMAN:

I am James H. Lockhart, Vice President and General Counsel of the Baptist Foundation of Oklahoma. I appear today on behalf of the Baptist Foundations of Oklahoma, Louisiana, and Texas, and several other charitable organizations and institutions--including Maryville University, the Sierra Club, the University of Arkansas, and the National Society of Fund Raising Executives--to urge the Subcommittee's favorable consideration of a measure to correct two minor defects in the Generation-Skipping Transfer tax law which unintentionally operate to discourage charitable giving.

I would especially like to thank Congressman Brewster, of my home state of Oklahoma, and Congressman Gephardt for their special request to the Chairman that I be permitted to testify here today.

First, some background on my organization. The Baptist Foundation of Oklahoma is the trust agency of the Baptist General Convention of the State of Oklahoma. Our role is to receive and administer gifts for Southern Baptist churches, ministries, agencies and institutions, which provide a variety of educational and social services in Oklahoma and elsewhere.

The Baptist Foundation of Oklahoma, for example, distributes over $1,000,000 annually for direct services to troubled children and teenagers. The Oklahoma Baptist Convention runs ten children's homes which provide residential care for children whose parents are deceased or unable or unwilling to care for them. The Convention also operates crisis pregnancy centers, a maternity home, and youth counseling programs. Through these efforts, we provide help to almost 10,000 young people in Oklahoma each year.

The Oklahoma Baptist Convention also owns and operates seven retirement centers, providing support and assistance to senior adults throughout the State of Oklahoma. In addition, the Baptist Foundation funds The Oklahoma Baptist University, a school of 2,400 students in Shawnee, Oklahoma.

Finally, through the Southern Baptist Convention, charitable ministries supported by our Foundation are given the opportunity to do their work throughout the United States and the world.

With each year, it seems that the need for our services continues to grow. To support the work of our agencies and institutions, the Baptist Foundation depends upon the support of its many donors and benefactors. By far, the largest source of our funding is gifts from individuals, ranging from thousands of small donations to, in some cases, very substantial gifts and bequests.

As someone who has been involved in charitable fundraising for a number of years, I would never claim that the sole, or even principal, motivation for charitable giving is tax law treatment. Baptist churches were the beneficiaries of charitable donations long before philanthropy was recognized in the tax code.

Nevertheless, in my experience, while the tax law may not affect an individual's initial desire to give, it often does affect the size of the contribution that is made, especially in the case of larger gifts through an estate plan. For this reason, we should always take care to ensure that the tax law does not discourage charitable giving where unnecessary to advance other goals of tax policy.

Unfortunately, this type of needless disincentive to charitable giving exists today in a little-known part of the Generation-Skipping Transfer tax law. As this Committee is aware, the GST statute imposes a separate tax in addition to regular estate or gift taxes when property is transferred to a person more than one generation younger than the donor. The GST tax is designed to eliminate the transfer tax advantage of "skipping" a generation in a gift or bequest--for example, by transferring property to a grandchild instead of a child.

An important exclusion in the GST law provides that if a child of the donor is deceased at the time of the transfer, then a gift or bequest to that child's children--the donor's grandchildren--will not bear GST tax. With this "predeceased parent exclusion," Congress recognized that because the child was not being "skipped" for tax avoidance reasons, it would be unfair to impose the GST tax on top of estate or gift taxes. This is important, because combined application of the GST tax and transfer taxes can be extremely severe--up to almost 80 percent of the value of the property transferred.

The language of this predeceased parent exclusion, however, is unfairly restrictive in two significant respects:

First, the exclusion is limited to the donor's lineal descendants--grandchildren--only; a childless individual confronting similar circumstances is denied the exclusion. For example, a donor who outlives his or her spouse, siblings, nieces and nephews, and wishes to give property to grandnieces and grandnephews--the donor's only living relatives--will be subjecting the transfer to GST tax, even though there is clearly no attempt at transfer tax avoidance. Any individual facing this very high level of taxation on a gift or bequest will almost certainly reduce charitable giving in order to increase the available gift or bequest to his or her heirs.

Second, the exclusion is only applicable to direct gifts or bequests to qualifying grandchildren; it does not apply to any type of transfer through a trust, including a common type of trust that provides income to a charity for a period of years and then distributes the trust property to grandchildren. These types of charitable trusts are very important sources of support for the Baptist Foundations and the other charitable organizations I represent here today. Under the GST tax, so long as the intervening ancestor is deceased at the time of the transfer, there is no tax policy reason to condition the exclusion on the form of the transfer. Yet, by having this limitation in the exclusion, charitable giving is unnecessarily discouraged.

Having carefully reviewed these provisions and the anomalies they produce, we are confident that Congress could not have intended these results.

The Baptist Foundation of Oklahoma and the other organizations I represent here today urge Congress to amend the GST statute to correct these problems. We believe that if such changes are made, it will help support charitable endeavors of all kinds while ensuring that the public policy behind the GST tax is consistently applied.

Included with my written statement is suggested language to accomplish these changes, along with a more detailed explanation of the proposed amendments.

I would be pleased to answer your questions, if any, and I again express my appreciation for the opportunity to convey my views to you here today.

PROPOSED STATUTORY LANGUAGE
GENERATION-SKIPPING TRANSFER TAX AMENDMENTS

(e) SPECIAL RULE FOR PERSONS WITH A DECEASED PARENT.-

(1) IN GENERAL.--For purposes of determining whether any transfer is a generation-skipping transfer, if an individual who has an interest in property--

(A) is a descendant of a grandparent of the transferor (or the transferor's spouse or former spouse), and

(B) at the time the transfer from which such interest is established or derived is subject to a tax imposed by Chapter 11 or 12 upon the transferor (and if there shall be more than 1 such time, then at the latest such time), such individual's parent who is a lineal descendant of such grandparent is dead,

such individual shall be treated as if such individual were a member of the deceased parent's generation, and any descendant of such individual shall be treated as belonging to the generation to which a parent of such descendant would be assigned without application of this subsection.

(2) REAPPLICATION OF SUBSECTION.--This subsection shall be reapplied until such individual is treated as belonging to the generation which is 1 generation below the lower of --

(A) the transferor's generation, and

(B) the generation assignment of a living ancestor of such individual (and, if there shall be more than 1, then the youngest of them) who is also a descendant of such grandparent, and the generation assignment of any descendants of such individual shall be adjusted accordingly.

EXPLANATION OF PROPOSED STATUTORY LANGUAGE
GENERATION-SKIPPING TRANSFER TAX AMENDMENTS

The statutory provisions governing "move up" for lineal descendants of the transferor are presently contained in paragraph (2) of Section 2612(c). Section 2612(c) deals entirely with direct skips. Since the proposed language would make move up possible with respect to any kind of generation-skipping transfer, and not just direct skips, it would seem appropriate for such language to appear in a Code section other than Section 2612(c). Section 2651 deals generally with generation assignment. The amendments are therefore proposed as a new subsection (e) to Section 2651. Under this format, present subsection (e) of Section 2651 would be redesignated as new subsection (f), and present Section 2612(c)(2) would be deleted.

Under new Section 2651(e)(1), move up would be available with respect to persons having common ancestry with the transferor's grandparent, or the grandparent of the transferor's spouse or former spouse. There would thus be a symmetry between the new statute and Sections 2651(b)(1) and (2), which use the grandparent of the transferor or the transferor's spouse or former spouse to ascertain generation assignment generally.

If a beneficiary with an interest in property is a descendant of a grandparent of the transferor (or a grandparent of the transferor's spouse or former spouse), new Section 2651(e)(1) would move the beneficiary's generation assignment to that of his or her parent. Move up would occur if the parent were also a descendant of such grandparent, and if the parent is deceased when the transfer from which the interest arises is subject to estate or gift tax upon the transferor.

Direct skips under the proposed subsection would be treated in the same fashion as under present Section 2612(c)(2). Application of proposed Section 2651(e)(1) to taxable terminations and taxable distributions can be illustrated by example.

If a transferor with one living child having children of his or her own and with living grandchildren by a deceased child were to establish an irrevocable trust for the benefit of his descendants living from time to time in a transfer subject to gift tax, the grandchildren by the deceased child would be moved up to the deceased child's generation. Any such grandchild would be an individual having an interest in property who would be moved up to his or her parent's generation, because the parent is deceased at the time the transfer creating the individual's interest is subject to gift tax. Any distributions during the term of the trust to such grandchild would not be taxable distributions subject to generation-skipping tax. Any distributions to the transferor's grandchildren by the surviving child during the term of the trust would be taxable distributions. If the trust terminates upon the death of the surviving child and trust assets are distributed outright to the transferor's grandchildren living at such time, the death of the surviving child would constitute a taxable termination with respect to assets passing to such child's own children, but not as to assets passing to the children of the predeceased child.

Under proposed Section 2651(e), if a transfer is subject to gift or estate tax more than once, eligibility for move up is to be determined at the most recent time the transfer is subject to tax. As an illustration, assume that a transferor establishes an irrevocable trust retaining the right to income for life, with distribution upon his death to his then living descendants, per stirpes. In this illustration, the establishment of the trust constitutes a taxable gift of the remainder interest in the trust.

If a child of the transferor were to predecease the transferor and the trust were to be included in the transferor's gross estate under Section 2036 by virtue of the retained income interest, the grandchildren of the transferor by such child would be moved up and treated as members of the child's generation. Distribution to such grandchildren after the transferor's death would not be subject to generation-skipping tax, even though their parent was living when the trust was established.

Paragraph (2) would permit a move up of several generations. A beneficiary could be moved up until he or she were assigned to a generation which is one generation below the transferor's generation or, if lower, the generation assignment of his or her youngest living ancestor who is also a descendant of a grandparent of the transferor (or the transferor's spouse or former spouse). Thus, if the beneficiary has no living ancestor, the beneficiary could be moved no higher than one generation below the transferor's generation.

Mr. JACOBS. Thank you, sir.

Mr. Pennell.

STATEMENT OF JEFFREY N. PENNELL, RICHARD A. CLARK PROFESSOR OF LAW; AND DIRECTOR, GRADUATE LL.M. PROGRAM IN TAXATION, EMORY UNIVERSITY SCHOOL OF LAW, ATLANTA, GA.

Mr. PENNELL. Thank you, Mr. Chairman, I am Jeff Pennell. I teach wealth transfer taxes at Emory University School of Law in Atlanta. I am here to support these two changes to the generation-skipping transfer tax.

I thought it might be useful to speak for a moment about what the provision we are dealing with was involved, designed to do in the code and why the changes are not at variance with that objective.

Back in 1976, the original generation-skipping transfer tax allowed a loophole that would permit a wealthy individual to do what was known as layering or leapfrogging. The objective to avoid the tax would be for me to split my wealth and leave a certain portion of it directly to my grandchildren; by avoiding a trust that benefited child for life and then out to the grandchild, I could escape the generation-skipping tax.

Congress concluded that this was inappropriate, because the opportunity was typically available only to the most wealthy donors. So Congress enacted the direct skip tax, which says that if I go directly to a grandchild with my wealth, the generation-skipping tax will apply.

At the very last minute in drafting that provision, the actual legislative drafter recognized that there was no tax avoidance if the reason I left my property directly to a grandchild was because my child—that is the grandchild's parent—was deceased. So this predeceased parent exclusion was added to the code at the very last minute.

An example illustrates the problems with this provision. If it were my sister whose child were deceased, she could leave her estate directly to her grandchild free of the generation skipping tax.

The problem we confront, which was not really considered at the time, was that if I were leaving my estate to my sister's family, because I have no relatives, no descendants of my own, this particular exception does not apply.

So that if my sister's property goes to her grandchild, you escape the tax. It does not apply. There is no need for this tax to be imposed at that point. But if I give my property directly to her grandchild, this tax does apply.

As far as we can tell from the legislative history, there is no reason for that disparity in treatment as between her lineal descendants and my collateral heirs. So one of the changes here is to correct that disparity.

The other problem with this provision, as Mr. Lockhart points out, is that it does not apply if my estate, or for that matter, my sister's estate, goes into trust for a short period of time. He has illustrated, for example, if my sister or I created a trust for the benefit of charity for a few years and at the end of that term, the property dropped to her grandchild, this tax will apply.

She could avoid the tax by simply leaving her entire estate to her grandchild. She would forego the charitable deduction and the charity would lose the benefit.

The other place where this could come up. Let's imagine, for example, as an academic, I don't get paid as much as some people; I don't save as well as I should. My sister says you are going to have trouble making it through your later years; I will put my estate in trust for your benefit, Jeff, and when you die I will send it to my grandchild.

The same thing she could have done with her property if I were not a beneficiary, would have been tax free, now where she creates this limited life estate in me, her sibling, or anyone else at her generational level and then at the death of the beneficiary, the property drops to her grandchild and the tax applies. Again, there appears to be no tax policy justification for that disparity. So the other correction to this statute is designed to deal with that problem.

Thank you very much.

Mr. JACOBS [chairing]. Good presentation.

[The prepared statement follows:]

STATEMENT OF JEFFREY N. PENNELL

Richard H. Clark Professor of Law
Director, Graduate LL.M. Program in Taxation
Emory University School of Law
Clifton Road at North Decatur NE
Atlanta, GA 30322
(404) 727-6816

Testimony In Support Of Changes in the Predeceased Parent Exclusion to the Generation-Skipping Transfer Tax

Before the Subcommittee on Select Revenue Measures
Committee on Ways & Means
United States House of Representatives
Hearings on Miscellaneous Revenue Issues

September 23, 1993

MR. CHAIRMAN:

I am Jeffrey N. Pennell, a Professor of Law at Emory University School of Law in Atlanta, Georgia, where I also serve as Director of the Graduate LL.M. Program in Taxation. I am a Member of the American Law Institute, an Academic Fellow and Regent of the American College of Trust and Estate Counsel, an Academician of The International Academy of Estate and Trust Law, and a Council Member of the Real Property, Probate and Trust Law Section of the American Bar Association. I have written and lectured extensively on U.S. estate and gift tax law, including Chapter 13 of the Internal Revenue Code, known as the Generation-Skipping Transfer (GST) tax law. I.R.C. §§ 2601-2663.

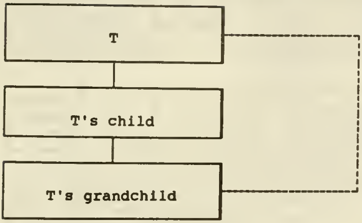
I appreciate the opportunity to testify in support of two minor changes to the GST tax that would, if enacted, further the stated policy of the GST tax and improve the consistency and fairness of its application. My testimony is in my individual capacity as a legal scholar, and not on behalf of any organization.

Although the GST tax law is complex, the principle behind the tax is to ensure that federal wealth transfer tax is not avoided when property is enjoyed and then transferred from one generation to the next.

Prior to enactment of the original GST tax in 1976, it was possible through a variety of arrangements that suspended outright ownership of property to transfer wealth through many generations without incurring estate or gift tax. These transfers were the target of the GST tax.

In greatly simplified form, the GST tax is imposed on the transfer of property to beneficiaries more than one generation below the transferor. The most common example of a transfer subject to the GST tax is a gift or bequest from the transferor to his or her grandchild that bypasses or "skips" the transferor's living child. This transfer is illustrated in Figure 1.

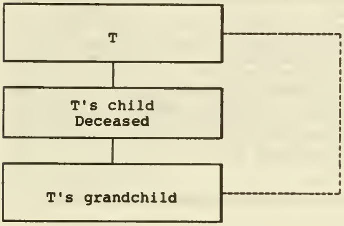
Figure 1. Generation-Skipping Transfer



Gift or bequest to T's grandchild that "skips" living child.

The changes to the GST tax that I support concern a limited exception in the law known as the "predeceased parent exclusion." I.R.C. § 2612(c)(2). This exclusion covers property transferred to a grandchild of the transferor if the grandchild's parent who was the transferor's child is dead at the time of the transfer. Under this "predeceased parent exclusion," the grandchild is deemed to "move up" one generation to that of his or her deceased parent and the GST tax does not apply. This situation is shown in Figure 2.

Figure 2. Predeceased Parent Exclusion

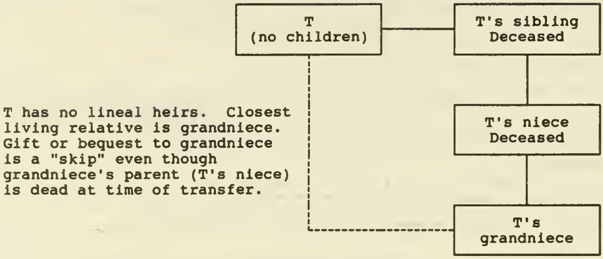


Gift or bequest to grandchild if grandchild's parent (T's child) is dead at the time of the transfer-no "skip".

The rationale for the predeceased parent exclusion is that there is no tax avoidance intent if the child is "skipped" by the transferor only because the child predeceased the transferor.

As currently drafted, this predeceased parent exclusion is limited to the transferor's lineal descendants only, and does not apply to collateral heirs in similar circumstances. Thus, for example, if a childless person outlives his or her spouse, descendants, siblings, and nieces and nephews and wishes to devise property to grandnieces and grandnephews, the GST tax will be imposed even though there is no motive or intent to avoid taxes, just as in the case of an individual who outlives his or her children and transfers property to grandchildren. This situation is depicted in Figure 3.

Figure 3. Gift to Collateral Heir With Predeceased Parent

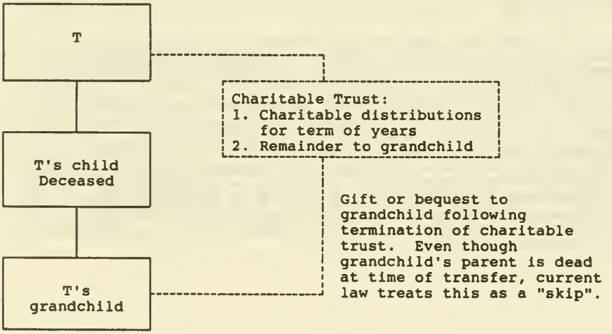


T has no lineal heirs. Closest living relative is grandniece. Gift or bequest to grandniece is a "skip" even though grandniece's parent (T's niece) is dead at time of transfer.

In my judgment, there is no tax policy justification to distinguish between lineal and collateral heirs in these circumstances. Although there is no legislative history on this particular point, it appears that the only reason collaterals were not included in the predeceased parent exclusion when enacted is because this unusual order of death situation was overlooked. It is improbable that Congress intended to create this inconsistency.

A second problem with the predeceased parent exclusion is that it applies only to direct gifts or bequests to a grandchild (a "direct skip" in the language of the GST statute) and does not apply to taxable terminations or taxable distributions from a trust. This means that a transfer excluded from GST tax when made by a direct gift or bequest would be subjected to GST tax if made through a trust distribution. The most common situation affected by this limitation on the exclusion is if the transferor wishes to establish a trust to pay income to a charity for a specified number of years, and then distribute the remainder to his or her heirs. This situation is illustrated in Figure 4.

Figure 4. Transfer Through Charitable Trust Termination



Gift or bequest to grandchild following termination of charitable trust. Even though grandchild's parent is dead at time of transfer, current law treats this as a "skip".

The creation of a charitable lead trust, no matter how short in duration it may be, has the effect of disqualifying this transfer from the predeceased parent exclusion. If a member of the generation immediately succeeding the transferor (a child, as the law stands now, or a niece or nephew if changed to cover collaterals) dies before the trust is created and therefore never has an interest in the trust, it is inconsistent with the objective of the predeceased parent exclusion to impose the tax. Just as in the case of a direct skip, there is no tax avoidance and no abuse.

I have suggested in my treatise on estate planning a way to avoid the imposition of the GST tax here while accomplishing the same result. A portion of the property could be distributed outright to the charity, so as to produce the same charitable deduction available under the charitable lead trust approach, and the balance of the property would be distributed to the grandchild. See Casner & Pennell, Estate Planning § 11A.4.3 n.10 (Supp. 1993). This alternative plan would qualify for the predeceased parent exclusion under current law. However, with certain types of property, an outright gift to the charity may not be viable. For example, because of the difficulty of fragmenting ownership of a closely-held business, the transferor may abandon the charitable gift entirely.

Given Congress' recognition of the charitable lead trust as a desirable mechanism to encourage transfers that benefit charity, the GST tax should not produce dramatically different results based upon the manner in which the transferor chooses to benefit the charity. Because no abuse exists under either planning approach, no tax policy justification appears to support imposition of the GST tax in the case presented in Figure 4, but not under the available planning alternative.

Furthermore, conditioning the applicability of the predeceased parent exclusion on whether the transfer is direct or indirect seems inconsistent with the overall design of the GST law. As with the limitation of the exclusion to lineal descendants, the limitation to direct skips was most likely an oversight. The legislative history of the GST statute shows that Congress sought to eliminate differences in treatment between direct and indirect transfers. See Staff of Joint Comm. on Tax'n, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986 at 1263. The predeceased parent exclusion does not fully achieve that goal as currently written, and the recommended legislative changes would eliminate the disparity.

I respectfully urge the Subcommittee's favorable consideration of amendments to the GST tax to extend the predeceased parent exclusion to cover both collateral heirs and trust distributions and terminations. In making this recommendation, I am joined by many of my professional colleagues in the estate and gift tax field, including members of the Real Property, Probate and Trust Law Section of the American Bar Association.

I again express my gratitude to the members of the Subcommittee for the opportunity to testify in support of these needed changes in the GST tax law, and I would be pleased to answer any questions.

Mr. JACOBS. Mr. Hinely, Mr. Gibbons wanted to ask you some questions about your problem and he had to run down to—no, I think he flew—down to Florida to have that meeting, I guess, with the President today. So here are the questions.

Are you ready? We have a professor. Are you ready to take a quiz.

Mr. HINELY. Yes, sir, I am ready. If I am not, I shouldn't be here.

Mr. JACOBS. Let's see if I am prepared to give it here.

Question. Treasury has taken the position that imposing and collecting an excise tax such as the one proposed, I guess on the carbon dioxide, would impose substantial complexities and administrative costs. As a businessman, are you aware of any recordkeeping that would be required, that is not already done, to trace the sales of carbon dioxide by ethanol producers?

And, second, as a businessman, do you think the ultimate tax remedy would be many more complex or administrative burdens that some of the other Tax Code provisions with which you might be familiar?

Of course, the second one answers itself, but——

Mr. HINELY. Mr. Chairman, I can't—to me, it is such a straightforward simple answer. It is so simple, it defies, probably, explanation.

Any businessman, and especially filling out a tax form, has to report income, revenue, so forth, salary and bonuses, everything. And in our business we report, the company reports its income as revenue. Well, there is a bottom line there, and every month every company knows the total production of its tonnage production in a year.

My company, say, produces 160,000 tons of CO_2 a year. That is the bottom line. Average price of $76.00. And the six or eight ethanol companies, who are making and selling CO_2, they have this information. It is there, and they can just simply put it on the bottom of the tax form, the tonnage produced and tax it $15 per ton.

They don't have to keep any additional records. They have the information. They are not going to go out here and chase around all the buyers and consumers and the bottlers that buy carbonation.

They have that information on their financial statement. It is straightforward there. It is very simple.

And due to the complexities of the problems they are causing, whatever it took to do it, like I say again, in the sense of fairness and everything, I think this is an unfair thing upon my industry. We are just talking about taxing the ethanol producers now that sell CO_2. Not all of them are selling CO_2.

When they are taking that tax-subsidized product and making another one and selling it and going out and wreaking havoc—I have a bottler down in Charlotte just a few months ago. I went down and cut my price $40. I told him I can't meet that price, and I explained the situation. He says: "You mean, they are getting theirs for free, this product free from the tax subsidy?"

He said: "Well, he would write his Senator." I said: "You can write him, but," I said, "he is from a tax subsidy State and he is not going to hear you."

Mr. JACOBS. Let's try the second question. There are four in all.

Your written statement says you do not propose any particular solution to the problem. The committee has before it a concrete and precise proposal to impose a tax of $15 per ton excise tax on the sales of carbon dioxide by ethanol producers. Where did that number come from and would it solve the problem?

Mr. HINELY. That number is a minimum. Our cost when we go to buy CO_2 from an anhydrous ammonia or DuPont over here in Richmond where they make acatylar from an acid neutral solution, we pay them a "royalty," we call it, for the raw gas. And that raw gas runs from, right now, $13 to $23.

We pay Shell off the pipeline in Mississippi up to $23 a ton. $15 is a minimum number. I mean that is the cost of the raw gas, and, besides the manufacturers of the ethanol, they are even getting a free ride because the same people producing the ethanol are producing the CO_2 on the side.

They don't even have a dollar, a dollar-and-a-half labor cost. And incorporated in that is their electricity cost they have thrown in, too. They have a free ride all the way.

So $15, we are just saying tax it, at least that much, that is all. Or I can turn it around and say I am not here for a handout, but how about allowing me a $5 tax credit then to level the playing field?

I would be glad to put down my 160,000 tons a year, plus a $5 tax credit on that. That would be fine.

But I am bringing to the Congress a method to raise more income, and in fairness, that is all. You don't have many people coming in here and saying here are the means to correct a terrible travesty. And, to me, for free enterprise, I have never seen anything like this.

It is unbelievable. I guess I get very emotional about this thing. Of course, when you have something you have been working at it for nearly 40 years, you get emotional about it.

Mr. JACOBS. Well, Mr. Hinely, you are a very special person in more ways than just proposing new revenues.

The third question is, and this is a Sam Gibbons-type question the way it is put.

Mr. HINELY. Yes, I know Sam.

Mr. JACOBS. Yes. When did the carbon dioxide industry first bring the existence of this problem to the attention of the Congress? How bad was the problem then? How bad is it now? And here we want a revelation. And how much worse can it get before it is too late?

Mr. HINELY. That is a good question. Good question.

Mr. JACOBS. Mr. Gibbons' question.

Mr. HINELY. When the ethanol manufacturers in Illinois and Iowa started this 6 or 7 years ago, when they started to get this tax credit for the ethanol makers, they found out, somebody, they could make CO_2 plants and sell another product. Of course, they were only penetrating the Midwest, the Chicago and Midwest market, and it was not touching me in the Southeast until the last couple of years.

But when it really got my attention and really had an impact on me, when Julius Rubin here, a carbonater who operates in New York and Pennsylvania, 4 years ago he had to sell his business. He could not compete against it. I said, Julius, this is not right, we should do something about it.

Through our association, we have been battling and fighting, but we just have not been able to get to first base. This is a small thing. And a lot of people—the CO_2 industry is not a large, a half-billion-dollar industry. Probably supports 4,000 families, we estimate. And not large. But, still, however large and however small, a great injustice has been brought onto the free enterprise system and it can be easily corrected by charging either $15—and as far as administrating it, that is the simplest thing. They can report *x* number of tons sold a year and put 15 times that. I would like to have the responsibility of doing it.

Did that answer your question, sir?

Mr. JACOBS. No, it does not. That answers Mr. Gibbons' questions.

Mr. HINELY. Oh, all right. But when Mr. Rubin, when he went out of business, that got all our attention in the association and we started talking about it.

But since then, in the last 2 years, they have penetrated, sending product from Illinois, Illinois to Florida, and still competing like that against me down there and it is unbelievable. I cannot compete against that.

Mr. JACOBS. Mr. Hinely, this is supposed to be a quiz and it is beginning to look like a final exam.

Mr. HINELY. I am happy to have it. I am delighted to have this occasion, and I want to thank you again.

Mr. JACOBS. Don't thank me. There is one more question here.

Mr. HINELY. OK, yes, sir. Shoot.

Mr. JACOBS. Don't thank me, you can flunk yet, I don't know. So far you have an "A."

The final question is, and I am quoting Mr. Gibbons, I know you have not gone this far in your testimony, but wouldn't one solution to your problem simply be, and you notice Mr. Gibbons does not split his infinitive here, simply be to repeal the ethanol subsidies which are causing the problem?

Mr. HINELY. That is a loaded question.

Mr. JACOBS. I know.

Mr. HINELY. That would be a simple thing to stop a lot of these subsidies. As far as a businessman, we don't need them, period. But I know when you tell—when you are going up against that group, forget it. That is like asking me to get a group together and move the Rock of Gibraltar and put it in the New York Harbor, because we have already ran up against that. Because the people who have won the subsidy have roots into the statehouse, the White House, Capitol Hill. You can forget that one.

We would like to see them eliminate, yes, eliminate the subsidy to that, but they are trying to help the farmers. And I have no problem with helping the farmers, but give it to the farmers. Don't give it to giant $3.5 billion corporations. And the thing about it, there are two other big firms—and I will mention the names—Cargill—is starting up in Iowa. They are getting into this business, and there will be one or two others.

This is going to get worse. This is going to get worse. And if we don't start doing something about seeking relief, like I say, in 3 or

4 years, I will be sitting back there with Mr. Rubin. I will be out at the lake fishing there, but I won't have much to fish with, and I have worked hard for what I have.

Mr. JACOBS. You know something, I am not so sure you couldn't make more money on television on one of these night talk shows.

Mr. HINELY. Well, they said I should go into politics. I had dinner with——

Mr. JACOBS. Plus, you could carry on this business and do that, because that, quite literally, is moonlighting on a clear night.

Mr. HINELY. I have enough faith in my government. This has really shaken me.

Mr. JACOBS. Well, I think you make out a very strong case.

Mr. HINELY. I couldn't believe, in the sense of fairness, something—they ought to do something about it, and they will do something. I think an enlightened Congress, knowing all the facts about this thing, will correct it. I have that much confidence.

Mr. JACOBS. Well, I hope so. I think you are right.

Mr. HINELY. And I appreciate very much you and the committee taking the opportunity and the time to listen to me.

Mr. JACOBS. I will say this, if you have not enlightened the Congress through the record, I don't believe anybody could.

Mr. HINELY. Thank you, sir, and I will be glad to come back and face them all.

Mr. JACOBS. Do you know Jake Pickle?

Mr. HINELY. Who?

Mr. JACOBS. Jake Pickle, the Congressman from Texas. He used to be LBJ's Congressman.

Mr. HINELY. No, sir.

Mr. JACOBS. You should get to know him, because I believe you are related some way or another.

Mr. HINELY. Why, he talks as much as I do?

Mr. JACOBS. Yes, sir, and he has a lot of good one-liners, too.

Mr. HINELY. No, sir, I don't know him. I'm from Florida. Born and reared in Miami and moved to Orlando when it was just a small sleepy little town.

Mr. JACOBS. Some great grandfather might have been a traveling salesman, you don't know.

Mr. HINELY. That is what my wife calls me.

Mr. JACOBS. You said that what you got out of it when you got out of the service. And I used to say that I was in the Marine Corps for 2 years, in infantry combat for 1, and I finally got out of it what I wanted: Me.

So we thank you for your contribution.

Mr. HINELY. I am having my 50th anniversary. I joined a Portable Surgical Hospital 50 years ago this week in New Orleans. In fact, we are having our 50th anniversary reunion week after next in Orlando. Out of 33 men, there are still 16 of us left, and two of the four officers.

But as I said, I came back in 1946 to go in business and I had all the confidence in the world and in our country and a free democracy, free enterprise. But up to now, with all this happening, I have been a bit shaken, and thanks again for listening to me.

Mr. JACOBS. Well, I find your testimony particularly tasteful, because I just finished reading Mr. Halbersam's new book on the

1950s, and what happened to the people that came out of World War II, and it is a pleasure to meet one.

Mr. HINELY. In fact, I might write one. Everyone else is doing it. You know what it would be?

The demise of the American entrepreneurs. That is what I would write.

Mr. JACOBS. Yes, sir.

Mr. HINELY. Thank you again, sir.

Mr. JACOBS. Thank you, sir. A+. We thank you for your testimony. You identify with precision and logic, I think, something that makes a lot of sense.

And, Mr. Maheu, as far as R&D credits are concerned, you know the majority of the Ways and Means Committee have been strong in support, and if I understood your testimony right. You are arguing for certaincy.

Mr. MAHEU. And inclusion of certain items that are in question.

Mr. JACOBS. Yes, I understood that, too.

My father was a lawyer and a judge, and he used to say every time the Indiana General Assembly met, it repealed his education. So I think there is something to be said for the certainty of law. Even a law that is not entirely just right, it usually makes itself right by practice.

But we thank you. It has not only been an edifying panel but it has been a gloriously entertaining panel. So we thank you all very much.

Mr. HINELY. Thank you very much.

Mr. JACOBS. That concludes our hearing.

Mr. HINELY. Thank you, sir.

[Whereupon, at 1:45 p.m., the hearing was adjourned.]

[See part 3 for submissions for the record.]

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